No. 13,039

United States Court of Appeals

For the Ninth Circuit

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, a national banking association, and EUGENE J. O'RILEY, as Trustee in Bankruptcy of the Estate of United Produce Company, a corporation, Bankrupt,

Appellants,

vs.

MERCHANDISE NATIONAL BANK OF CHICAGO, a national banking association,

Appellee.

BRIEF FOR APPELLANTS.

S. B. STEWART, JR.,
G. D. SCHILLING,
300 Montgomery Street, San Francisco 4, California,
MORSE ERSKINE,
ERSKINE, ERSKINE & TULLEY,
625 Market Street, San Francisco 5, California,
Attorneys for Appellants.

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No. 13039

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BRIEF FOR APPELLANTS.

I. STATEMENT OF PLEADINGS AND JURISDICTIONAL FACTS.

This appeal is from a judgment that plaintiff, hereinafter called "Merchandise", recover of defendant, hereinafter called "Bank of America", payments made by Merchandise to Bank of America aggregating $205,117.10, with interest.[1]

[1]If it be held that Merchandise is not entitled to recover these payments, there will be a credit balance of $30,934.76 in the Lofendo

A. Statement of pleadings.

Merchandise's complaint alleges that on November 23, 1948, there was a credit balance of $386,283.07 in a deposit account carried by Merchandise with Bank of America; that Bank of America paid Merchandise $183,235.47 of this balance, but refused to pay Merchandise the balance of $203,047.60; and that Bank of America owes Merchandise this balance with interest (I, 61-62).[2]

This amount of $203,047.60 is the aggregate of two sums, one for $89,813.10, represented by checks to which we will refer as "the four checks"; the other for $113,216.50, represented by checks to which we will refer as "the six checks".

Merchandise by its original complaint sought only to recover the amount of the six checks; but at the end of the trial the trial court granted Merchandise leave to file its amended complaint by which it seeks to recover the aggregate of the four and six checks.

Bank of America's amended answer to Merchandise's original complaint denied that Bank of America owed Merchandise any sum and alleged that Bank of America paid to Merchandise the entire balance

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account which Bank of America shall owe the one held entitled to it; whereas if the judgment is affirmed, there will be no credit balance in the account; and so if the judgment is affirmed Bank of America's loss will be $205,117.10, less $30,924.76, or $174,192.34, plus the interest allowed Merchandise by the judgment.

[2]In citing the record, we will not use the abbreviation "R" to designate the record. Of course, the Roman numerals in the citations of the record refer to the volume, the arabic numbers to the page.

to Merchandise's credit in its deposit account with Bank of America (I, 27-30).

The amended answer alleges by way of separate defense and counterclaim that for five months prior to November 15, 1948, United Produce Company, hereinafter referred to as "United", a Chicago commission merchant, and its agent, Lofendo, were engaged in what is known in banking as a "kite";[3] that one end of the kite was Merchandise's office in Chicago and the other end the office of the East Bakersfield Branch of Bank of America, hereinafter called "the Branch"; that if Merchandise is entitled to recover from Bank of America the amount it seeks to recover, Lofendo's account with the Branch will be overdrawn; that such overdraft will represent an extension of credit by Bank of America to Lofendo which Bank of America was induced to make to Lofendo by the fraud of United and Lofendo in carrying on the kite; that Merchandise by permitting the kite to continue after it knew or should have known that it was going on was in effect participating in such fraud and became liable to Bank of America for any damages it may suffer by reason of such fraud; that on October 20, 1948, Merchandise made false representations to Bank of America

[3]The answer describes the way in which the kite was carried on (I, 34-35); and Merchandise's reply to the answer admits that the kite was carried on as described in the answer (I, 16).

This fraudulent practice consists of the creation of credits in one bank by the deposit of checks of the agent of the "kiter" to the kiter's credit, and the deposit in the other bank of checks of the kiter to the credit of his agent in sufficient time to meet the agent's checks.

to induce it to continue to pay checks drawn on it by Lofendo payable to the order of United; and that by reason of the facts alleged in the defense Merchandise is estopped to revoke its payment of the checks (I, 33-45).

When at the end of the trial Merchandise filed its amended complaint, it was stipulated that Bank of America's amended answer should stand as an answer to the amended complaint (II, 827-830).

Bank of America filed as part of its answer an interpleader counterclaim against Lofendo, Eugene O'Riley, trustee in bankruptcy of United, and Merchandise. This interpleader counterclaim alleges in substance that if Merchandise does not recover in this case its payment of the four and six checks there will be a balance left in the Lofendo account of $30,920.36; that Merchandise, O'Riley and Lofendo have claimed this balance; and that Bank of America has no claim thereto and is ready to deposit the same in court; and it prays that Merchandise, O'Riley and Lofendo be required to interplead their claims to the balance (I, 48-54).

Merchandise answered that if it were held in the action that Merchandise is not entitled to judgment, then Merchandise claims the balance (I, 18-19); O'Riley filed an answer claiming the balance (I, 20-22); and Lofendo filed an answer disclaiming any interest in it (I, 7).

B. Statement of jurisdictional facts.

As alleged in the amended complaint and admitted by the answer, Merchandise is a national banking association located in Chicago, and Bank of America is a similar association located in California and the matter in controversy exceeds, exclusive of interest and costs, $3,000.00 (I, 61-62). And so the District Court had jurisdiction under section 1348 of Title 28, U.S.C.

This court has jurisdiction to review the judgment under Section 1291, Title 28, U.S.C. and Rule 73 F.R.C.P.

II. STATEMENT OF THE CASE.

When on November 17, 1948[4] the kite being carried on by United collapsed, Merchandise had in its hands checks aggregating more than $500,000.00 drawn by Lofendo on Bank of America to the order of United which were part of the kite. When the kite collapsed, these checks could not be collected and so Merchandise sustained a loss occasioned by the kite in excess of $500,000.00.

If the judgment in this case stands, Merchandise will have succeeded in recovering from Bank of America $203,047.00 of this loss, with interest, a most extraordinary result in view of the fact that Merchandise's loss arose out of the kite and that it either

[4]As all the events in this case took place in 1948, we hereafter in stating dates will refer only to the month and day and not the year; it will be understood that the year of each date will always be 1948.

had knowledge of the kite or failed by the grossest sort of negligence to discover it.

The important facts in the case are undisputed and the appeal is based entirely upon errors of law and erroneous and unwarranted inferences drawn by the trial court from the undisputed facts.[5]

When the Branch received as part of the kite checks drawn by United to Lofendo's order, it would either give Lofendo immediate credit for them or send them on to Merchandise for collection and payment. On November 10th the Branch received for deposit to Lofendo's account through the mail what we have already called the four checks, that is checks for $89,813.10 drawn by United on Merchandise and payable to Lofendo. On that date the Branch forwarded the four checks to Merchandise for collection.

Merchandise received the four checks on November 12th. On that date it debited the four checks against United's account, credited Bank of America, perforated the checks with a stamp reading "Paid November 12, 1948", and sent the Branch four instruments, to which we will refer as "advices of credit", each of which stated in substance that that one of the four checks referred to in it had been "paid" and its amount credited to Bank of America.

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[5]On the trial there was a conflict in the testimony with respect to what was said in conversations between officers of Merchandise and Bank of America which occurred on November 17th and 18th. For the purposes of this appeal we accept Merchandise's version of these conversations. Even so, as we will point out, the inferences drawn by the trial court from these versions were erroneous and unwarranted.

On November 13th the Branch received for deposit to the Lofendo account through the mail what we have already called the six checks, that is six checks aggregating $113,216.50 drawn by United on Merchandise and payable to Lofendo; and on that date the Branch sent them forward to Merchandise for collection.

Merchandise received the six checks on November 15th and on that date it debited them against United's account, credited Bank of America, perforated the checks with a stamp "Paid November 15, 1948", and mailed the Branch one advice of credit to the effect that the checks had been "paid" and their amounts credited to Bank of America.

Late in the afternoon of November 17th, after Merchandise had been told by Rosenthal, the secretary of United that United had engaged in transactions with Merchandise which would cause Merchandise a heavy loss, Frederick Messenger, then the controller of Merchandise, telephoned the Branch and talked with Frank Estribou, its manager. Messenger testified that in this conversation he told Estribou that United had perpetrated a fraud on Merchandise by pledging to it fictitious accounts receivable as collateral; that Merchandise had paid the six checks in error; that Merchandise was rescinding the advice of credit with respect to these checks and did not want the Branch to enter the credit or pay checks against it; and that Estribou replied that the Bank of America would not make such entry.

The trial court found that Merchandise did not pay the four and six checks; that Bank of America did not become indebted to Lofendo for these checks; and that Bank of America did not change its position in reliance upon Merchandise's payment of them and is therefore not a bona fide purchaser of them.

There is no dispute with respect to the essential facts upon which these findings are based; and so the question on this appeal is whether as a matter of law the trial court erred in making these findings. Bank of America contends that it did; that Merchandise paid the checks absolutely and unequivocally; that when it paid them Bank of America became indebted to Lofendo; and that its position was changed by their payment and that therefore it is in the position of a bona fide purchaser.

At the close of business on November 16th, prior to the telephone conversation between Messenger and Estribou on November 17th, Lofendo became indebted to the Branch in the sum of $172,094.84 on account of an overdraft. Bank of America contends that it acquired a banker's lien on the proceeds of the four and six checks to secure this indebtedness of Lofendo to it; that therefore it became a bona fide purchaser of such proceeds and so is entitled to retain them.

Bank of America also contends upon the basis of the undisputed facts that Merchandise received a substantial benefit from its payments of the four and six checks and therefore cannot recover these payments.

The trial court made no findings with respect to the allegations of Bank of America's answer that Merchandise either knew or should have known of the kite and so is precluded from recovering the payments. Bank of America contends that these allegations are a defense to the action and that therefore the trial court's failure to find respecting them is reversible error. It also contends that its counterclaim, which is based upon the fact that Merchandise knew or should have known of the kite, is a good counterclaim and that for this reason also the court's failure to make such findings is error.

Although the court did not find with respect to Merchandise's knowledge of the kite, it did find in effect that Bank of America was negligent in not discovering the kite. Bank of America contends that this finding is contrary to the undisputed testimony and is therefore erroneous; and also that even if Bank of America were negligent in not discovering the kite, the fact that Merchandise knew or should have known of the kite was nevertheless a good defense to Merchandise's claim.

The trial court also found that Merchandise never made any representations to Bank of America to induce it to pay checks drawn on the Lofendo account. Bank of America contends that the finding is contrary to the uncontradicted evidence and is erroneous.

On November 18th, Allen R. LeRoy, a vice-president of Merchandise, arrived in San Francisco from Chicago and had conversations with Roland T.

Duncan, an assistant vice-president of Bank of America, and with Kenneth M. Johnson, an attorney in Bank of America's legal department.

The trial court found in effect that in the telephone conversation between Messenger and Estribou of November 17th and in these conferences of November 18th Bank of America agreed with Merchandise not to act upon the advice of credit with regard to the six checks and to return this advice to Merchandise. In other words, the trial court found in substance that an agreement was made between Merchandise and Bank of America under which Bank of America agreed in effect that Merchandise's payment of the six checks should be rescinded and that Bank of America would repay the amount thereof to Merchcandise and would surrender whatever liens or other rights it might have with respect to the six checks and their proceeds. Bank of America, as it must on this appeal, accepts as true Messenger's and LeRoy's versions of the conversations. But it contends that their versions of the conversations show Merchandise's officers were not negotiating for a contract, but took the position that they had the right to rescind the advice and that they were directing its rescission; that Bank of America's officers merely acquiesced in this assertion of an alleged right; and that there was no intention to create a contract and none was created.

But Bank of America contends that if it be assumed for argument's sake that the alleged agree-

ment was made, then it was invalid and unenforceable, because not supported by a consideration, because based on a mutual mistake and because induced by Merchandise's false representations and its suppression or concealment of facts which it was under a duty to divulge.

The case involves many technical points. But underlying them all is this crucial fact: Merchandise is in reality seeking to recover part of a loss suffered by it because of the kite of which it knew, or should have known, and which it allowed to continue; in justice it should not be permitted to recover from Bank of America any part of the loss which it brought upon itself.

III. SPECIFICATIONS OF ERROR RELIED UPON BY BANK OF AMERICA.

1. The trial court's findings, that the four and six checks were not paid or collected (I, 108-109; 100-101; 114), are erroneous.

2. The trial court's findings, that when Merchandise debited the four and six checks against United's account there were apparent credit balances in the account, but that there were in fact no such balances but an overdraft of $500,000.00 (I, 108-109; 100-101), are erroneous.

3. The trial court's findings, that under an agreement between United and Merchandise the Lofendo checks delivered by United to Merchandise as remittances were taken by Merchandise for collection only

and that these checks created conditional credits in United's commercial account with Merchandise (I, 99), are erroneous.

4. The trial court's findings, that Bank of America did not become indebted to Lofendo for the four and six checks (I, 114), are erroneous.

5. The trial court erred in not finding that Bank of America had a banker's lien on the proceeds of the four and six checks to secure the indebtedness owing it by Lofendo, and that consequently Merchandise is not entitled to recover the payments.

6. The trial court erred in not finding that as Merchandise received substantial benefit from its payment of the four and six checks, it is precluded from recovering these payments.

7. The trial court's findings, that Bank of America prior to receiving notice of Merchandise's claim did not change its position in reliance upon the payment of the four checks and is therefore not a bona fide purchaser of such payment (I, 109-111; 114), are erroneous.

8. The trial court's findings, that Bank of America, prior to receiving notice of Merchandise's claim, did not change its position in reliance on the payment of the six checks and was therefore not a bona fide purchaser of such payment (I, 103-104; 114), are erroneous.

9. The issue, whether Merchandise either knew of the kite or was guilty of negligence in not discovering it, was material, and therefore the trial court erred in not finding with respect to it.

10. The trial court's findings, that no act or omission of Merchandise proximately caused any loss sustained by Bank of America (I, 112), are erroneous.

11. The trial court's findings, that it is not true that Merchandise ever made any representations to Bank of America to induce it to pay checks drawn on the Lofendo account to the order of United or to give anyone credit for any checks of United drawn on Merchandise to the order of Lofendo, and that it is not true that Bank of America in reliance on representations of Merchandise ever paid any checks drawn on the Lofendo account or ever gave anyone credit for checks drawn by United on Merchandise (I, 113), are erroneous.

12. The findings of the trial court, that as early as October 22nd Bank of America became suspicious that the Lofendo account was being operated as part of a check kiting operation and that on November 10th it became positive that this was so (I, 105-106), are erroneous.

13. The court erred in finding that, in the telephone conversation between Messenger and Estribou of November 17th and in the conferences between LeRoy and officers of Bank of America of November 18th, Bank of America agreed not to act upon the advice of credit with respect to the six checks and to return this advice to Merchandise (I, 101-103).

14. The court erred in not finding that, if such a contract were made, it was invalid and unenforceable because not supported by a consideration, be-

cause based on a mutual mistake and because induced by Merchandise's false representations and its suppression or concealment of facts which it was under a duty to divulge.

15. The court erred in finding that Bank of America became indebted to Merchandise in the amounts of the four and six checks (I, 115).

IV. ARGUMENT.[6]

A. THE SIX AND FOUR CHECKS WERE PAID, AND THE TRIAL COURT'S FINDING TO THE CONTRARY IS ERRONEOUS.

1. The relevant facts.

From time to time after September 6, 1948, checks drawn by United to the order of Lofendo came in the mail to the Branch in envelopes bearing the imprinted return address of the Bakersfield Inn, Bakersfield, California (IV, 1175). On some occasions when these checks arrived at the Branch immediate credit was entered in the amount of the checks in the Lofendo account; and on other occasions no credit was entered in the Lofendo account, but the checks were sent forward to Chicago to Merchandise on which they were drawn, under cover of a collection letter (IV, 1175-1176).

On November 10th the four checks arrived at the Branch in the mail; and on that day the Branch sent them with a collection letter to Merchandise.

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[6]The subject index of this brief at its beginning is in effect a summary of our argument and so in a sense is our statement of the case. And therefore we did not consider it necessary to precede our argument by a summary.

The four checks arrived at the office of Merchandise on November 12th. On that day Merchandise mailed to the Branch the advices of credit with respect to the four checks each of which described one of the checks and bore the stamp "Paid November 12 Merchandise National Bank of Chicago". On November 12th Merchandise perforated and cancelled each of the checks by a perforated stamp reading "Paid November 12, 1948". And on November 13th, Merchandise, pursuant to the practice of delayed posting,[7] charged the four checks against the commercial account of United as of November 12th; and on November 13th, Merchandise, pursuant to the same practice, credited Bank of America as of November 12th with the amount of the four checks on the ledger kept by Merchandise to show the transactions between it and Bank of America (I, 90-91; 301-306; deft's. ex. H, the ledger card of the account kept by Merchandise to show its transactions with Bank of America; and deft's. ex. HH, the commercial ledger of United's commercial account with Merchandise).

Merchandise never returned the four checks to Bank of America, nor did Merchandise at any time

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[7]It was stipulated that "in-clearings" meant checks drawn on Merchandise and presented to it through the clearing house, and that "counter work" meant all debits and credits other than in-clearings; that Merchandise posted all counter work on the next business day after the day on which it was handled, but the posting appeared under the date on which it was actually handled, that is, there was "delayed posting" of counter work; that Merchandise posted in-clearings of any day on that day as debits, but the posting occurred under the date of the previous business day, that is, there was "pre-posting" of in-clearings; and that Bank of America used the same system of posting (III, 959-961).

offer to do so, except that in Merchandise's closing brief in the trial court it made such an offer (I, 90).

On November 13th, the six checks arrived at the Branch in the mail; and on that date the Branch sent them with a collection letter to Merchandise (IV, 1176). The six checks arrived at the office of Merchandise on November 15th (IV, 1176). On that day Merchandise mailed to the San Francisco head office of Bank of America the advice of credit with respect to the six checks, which described all of the checks and bore the stamp "Paid November 15, Merchandise National Bank of Chicago" (IV, 1176). This advice of credit, deft's. ex. A, appears on page 94 of the record.

The advice of credit was received at the San Francisco head office of the Bank of America on November 18th, but that department of Bank of America had no function to perform with respect to it other than to treat it as a misrouted item and forward it by mail to the Branch where the collection had originated; and this was done as a matter of routine by the clerical staff (IV, 1177). It arrived at the Branch on November 19th (IV, 1177).

On November 15th Merchandise perforated and cancelled each of the six checks by a perforated stamp reading "Paid November 15, 1948". On November 16th Merchandise, pursuant to the practice of delayed posting, charged the six checks against the commercial account of United as of November 15th; and on November 16th, Merchandise, pursuant to the same practice, credited Bank of America as of November

15th with the amount of the six checks on the ledger kept by Merchandise to show transactions between it and Bank of America (I, 289-294). All of these acts were performed in accordance with the regular routine and practice of the Bank (I, 298).

Merchandise returned the six checks to Bank of America by Messenger's letter of November 19th (deft's. ex. D); but Bank of America returned them to Merchandise by Estribou's letter of November 22nd (deft's. ex. L). And then Merchandise by a letter of its attorneys dated December 3, 1948 (Ex. A of deft's. answer; I, 55-56), tendered them to Bank of America stating that it seemed "pointless to be mailing the checks back and forth".

When Merchandise performed these acts with respect to the four and six checks, it paid them unequivocally and absolutely.

2. Under the law the checks were paid.

Bank of America contends that an Illinois statute (section 207a of its Negotiable Instruments Act) in itself establishes that Merchandise paid the checks; and so it is first necessary to determine whether the Illinois law should be applied to the decision of this question.

It is true that as this is a diversity case the law of California should be applied. *Erie Railroad v. Tompkins,* 304 U.S. 64, 58 S.Ct. 817. But the law of California embraces its conflict of laws rules; and so under the doctrine of the *Erie* case those rules should be applied. *Klaxon Co. v. Stentor Electric Mfg. Co.,*

313 U.S. 487, 61 S.Ct. 1020. The contracts evidenced by the four and six checks were to be performed in Chicago, Illinois, by the payment of these checks by plaintiff. The California law is that the law of the place where a contract by its terms is to be performed governs all matters connected with its performance. Section 1646 of the California Civil Code; *Hutchinson v. Hutchinson,* 48 Cal. App. (2d) 12, 119 P. (2d) 214; *Monarch Brewing Co. v. George J. Meyer Mfg. Co.,* 9 Cir., 130 F. (2d) 582. And so under the California law the question whether the checks were paid is governed by the Illinois law. The same conclusion would be reached under the general law with respect to conflicts of law. 9 C.J.S. sec. 214, p. 463; 8 Zollman, Banks and Banking (perm. ed.) sec. 5603, p. 361, and sec. 5691, p. 455.

In 1948 section 207a of the Illinois Negotiable Instruments Act[8] (Rev. Stat. Ill., 1947, ch. 98, sec. 207a; Illinois Laws of 1943, Vol. 1, page 949) provided that a drawee bank has until the end of the next business day after presentation of a check to it by mail "to decide whether or not it will pay the check". This means, of course, that if it does not decide within that time to reject the check, the check is then

[8]In 1948 section 207a provided:

"The drawee bank named in a check presented to it by mail or through a clearing house association, or through a settlement with another bank or banks, or for deposit in an account in the drawee's bank is allowed until the end of the next business day following the day of presentation to decide whether or not it will pay the check."

The section was amended in 1949 to state in more detail the rules relating to the payment of checks; but, of course, the section as it stood in 1948 controls this case.

deemed to have been paid. Section 16c of the California Bank Act which was in effect in 1948 (in 1949 it was superseded by the California Banking Code) provided substantially the same thing as section 207a.[9]

LeRoy and Duncan had a telephone conversation on November 17th prior to the former's departure for California on the night of that day (II, 480). In this conversation LeRoy told Duncan that he believed that Bank of America had no right to reject checks for $57,694.97, which Bank of America had rejected on November 12th and returned to Merchandise, because it had delayed too long in rejecting them (II, 480). When LeRoy saw Duncan on the morning of November 18th, Duncan explained to LeRoy the routing of the three checks and LeRoy then agreed that Bank of America had rejected them in time (II, 480-481). This incident illustrates the point that if a bank does not reject a check within the time allowed it by the applicable statute, whether the Illinois section 207a or the California section 16c, it in effect pays the check. It also illustrates that Merchandise wants the benefit of this rule when it works in its

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[9]The provisions of section 16c of the Bank Act having this effect read:

> "* * * any check, note or other instrument providing for the payment of money and drawn on or payable at the same bank allowing such credit shall either be found good or else returned unpaid, or notice of dishonor duly sent, at or before the end of the next succeeding business day when such check, note or other instrument has been received during business hours and at or before the end of the second succeeding business day when such check, note or other instrument has been received after business hours."

favor, but wants to repudiate it when it works against it.

Section 207a in itself establishes that the checks were paid.

The Illinois courts have held without reference to section 207a that when a bank marks a check "paid" and charges it against the account of its depositor, it unequivocally manifests an intention to accept and pay the check and cannot thereafter change its position; and that this is so even though the payment of the check overdraws the depositor's account, or even though the bank at the time it pays the check has the right to apply the depositor's account to the payment of his indebtedness to it. *Gillette v. Williamsville State Bank,* 310 Ill. App. 395, 34 N.E. (2d) 552; *Hay v. First National Bank of Springfield,* 244 Ill. App. 286; *American Exchange National Bank v. Gregg,* 138 Ill. 596, 28 N.E. 839; *O. B. Avery Co. v. Highway Commissioner of Road District,* 363 Ill. 279, 2 N.E. (2d) 77.

In the case last cited the court said:

> "Where a bank receives a check drawn on the drawer's checking account in it, stamps the check paid, charges it to the account of the drawer and credits the payee with the amount, the check is regarded as paid. People v. People's Bank & Trust Co., 353 Ill. 479, 486, 187 N.E. 522, 89 A. L. R. 1328; American Exchange Nat. Bank v. Gregg, 138 Ill. 596, 28 N. E. 839, 32 Am. St. Rep. 171."

The law of other jurisdictions is the same. *Hallenbeck v. Leimart,* 295 U. S. 166, 55 S. Ct. 685; *Security National Bank v. Old National Bank,* 8 Cir., 241 F. 1; *Hayes v. Tootle-Lacy Bank,* 10 Cir., 72 F. (2d) 429; *Nineteenth Ward Bank v. First National Bank,* 184 Mass. 49, 67 N.E. 670; *First National Bank v. Noble,* 179 Ore. 26, 168 P. (2d) 354; *Spokane and Eastern Trust Co. v. Huff,* 63 Wash. 225, 115 P. 80; *Oregon Iron & Steel Co. v. Kelso State Bank,* 129 Wash. 109, 224 P. 569.

9 C.J.S. 502 states:

> "Where checks are sent to the bank on which they are drawn for collection, the collection and payment are ordinarily regarded as completed when the bank charges the checks on its books to the account of the drawer or where it charges them to the account of the drawer and marks them 'paid'."

Checks perform the function of money. The great bulk of payments in this country is made by checks. It is essential, therefore, that the question whether or not a check has been paid be governed by precise and certain rules. Otherwise there would be chaos, not only in banking, but in the entire business world. This is the philosophy underlying Illinois' section 207a and California's section 16c. And it is the philosophy underlying all clearing house rules requiring banks to reject checks presented in the clearings within a specified limited time or be deemed to have paid them.

3. **There were good balances to United's account when the checks were debited against the account.**

The ground upon which Merchandise mainly relies in contending that the checks were not paid is incorporated in the findings of the trial court that when it debited the checks against the account there were apparent credit balances therein, when in fact there were no such balances, but an overdraft of over $500,000 (I, 100).

It makes no difference whether there were good or only apparent credit balances to United's account when the checks were paid. Under section 207a a bank pays a check by not rejecting it in time even though such payment overdraws the account. And under the cases we have cited, a bank pays a check by stamping it paid and charging it against the account of the drawer even though such payment creates an overdraft in the account. But as a matter of fact this finding of the court is contrary to the undisputed evidence.

The copy of the ledger of United's commercial account with Merchandise, defendant's exhibit HH, shows that as of November 10th there was a balance of $7,673.09 to the credit of United in its commercial account with Merchandise. The evidence is that after the end of October, Merchandise was not paying against uncollected funds in its commercial account and so this balance of $7,673.09 was all collected funds (III, 1014). November 11th was a holiday and no entries appear on this ledger sheet as of that day. This ledger sheet shows that on November 12th, after

all checks, including the four charged against the account on that date, were deducted, the balance to the credit of United was $77.617.55.

Defendant's exhibit HH also shows that at the close of business on November 13th, which was a Saturday, there was a balance to the credit of United of $241,525.04; that on November 15th, which was Monday, the six checks, together with other checks, were debited to the account; that on that date amounts aggregating $76,093.55 were credited to the account; and that on the close of business on November 15th the balance to the credit of United was $176,650.65.

During the period from July 1st to November 17th Merchandise maintained a loan to United of $200,000.00, which was Merchandise's legal limit, that is, the largest amount which Merchandise, under section 34, Title 12, U.S.C., could loan any one person (III, 904; 951-953). United's indebtedness to Merchandise was secured by assignments of accounts receivable (III, 953). When on any day United had in its hands checks of debtors owing it accounts receivable assigned to Merchandise as security, United would endorse such checks and deliver them to Merchandise, together with a remittance sheet specifying the debtors who had delivered such checks to it and the amount of such checks (III, 981-984). Merchandise would thereupon apply such remittance (that is the aggregate amount of such checks) on account of United's indebtedness to it and on the same day Merchandise would make an additional loan to United in

the amount of such remittance so as to maintain United's indebtedness to it at $200,000.00 (II, 761-763). Although Merchandise made United a new loan on each day that a remittance was received and applied on account of United's indebtedness, the remittance was not a basis for such new loan, but such new loan was an independent transaction based on a new note and secured by a new collateral consisting in the assignment of new accounts receivable (III, 928-929).

Although Merchandise was making new loans to United in amounts far in excess of Merchandise's legal limit of $200,000.00, the net amount of its loans was kept at $200,000.00 in the following manner: On the fifth of each month United would execute to Merchandise a note for $200,000.00 maturing on the fifth of the following month. All other notes executed by United to Merchandise during such month to evidence additional loans made by Merchandise to United during that month would also mature on the fifth day of the following month. On the fifth day of each month, the note for $200,000.00 executed during the preceding month would be renewed by the execution by United to Merchandise of a new note in a like amount, and on the same date all other notes executed by United to Merchandise during the preceding month would be retired and paid by the application to them of the remittances delivered by United to Merchandise during the month during which such notes were executed. During each month the difference on any day between the aggregate re-

mittances received during such month and the aggregate of the notes executed during such month was maintained at $200,000.00. In other words, the remittances received during any month were considered as cash offsetting the indebtedness under the notes executed during any such month so that Merchandise considered it was not loaning United more than its legal limit. (Stipulation marked deft's. ex. NN, IV, 1275 to 1282; and deft's. ex. II, the note liability ledger of United with Merchandise; and deft's. ex. KK, the assigned accounts receivable ledger of United with Merchandise.) But it made each new loan before collecting the checks representing the remittances it received on the date the loan was made; so, if these checks were not collected, it would not be able to offset the amount of them against the loan, with the result that the indebtedness of United would exceed the legal limit by the amount of such checks (II, 504-505; 507-508).

As we shall show later, United delivered to Merchandise during the first sixteen days of November remittances consisting of Lofendo checks aggregating the enormous total of $998,326.98; and during this period Merchandise, pursuant to its practice of loaning United an amount equal to each remittance, loaned United this same amount and took United's notes to evidence the loans. (It was truly a fantastic state of affairs.)

The amounts of all notes executed by United to Merchandise were credited to its commercial account; and on November 13th approximately ninety percent

of the amount to United's credit in the account consisted in such credits (IV, 1176-1177).

After November 15th Lofendo checks aggregating $534,548.18, which United had delivered to Merchandise as remittances, were returned to Merchandise without having been paid, and Merchandise thereupon during the period from November 17th to November 28th exercised its right of setoff by charging such Lofendo checks against the amount to the credit of United in its commercial account (I, 231-237; III, 914-917; III, 787; plt's. ex. 4 for identification, consisting in the checks for $534,548.18; and deft's. ex. HH, the ledger sheets of United's commercial account with Merchandise).

The basis of Merchandise's contention that the balances to the credit of United when the four and six checks were charged against these balances were apparent and not good balance is that if these Lofendo checks aggregating $534,548.18 had been returned to Merchandise prior to November 12th when the four checks were charged against the account or prior to November 15th when the six checks were charged against it, there would have been no balance to the credit of United, but an overdraft in excess of $500,000.00.

Under the general law Merchandise had a right, which was optional with it, to offset any credit balance in United's account against United's indebtedness to it arising when the Lofendo checks were not paid. 9 C.J.S. 614-618. But Merchandise did not exercise this right until after November 15th.

The form of note executed by United to Merchandise (plt's. ex. 5) gave Merchandise the right to apply any balance to the credit of United against any indebtedness due by United to it before the maturity of such indebtedness. But this provision of the note cannot be of any help to Merchandise. Merchandise may have had the right to charge an unmatured indebtedness due it by United against United's account; but again we say that it did not exercise that right until after November 15th.

The trial court found that under the agreement between Merchandise and United the Lofendo checks delivered by United to Merchandise on account of accounts receivable constituted conditional credits in the amounts of such checks, subject to charge back at any time before actual collection of the funds (I, 99). As shown in the appendix to this brief, the finding is not supported by the evidence. But the point is not important. Assuming that Merchandise did not have an agreement permitting it to offset the amount in which United became indebted to it upon the dishonoring of the Lofendo remittance checks, still it had this right under the law. But the crucial fact is that it did not exercise the right until after the four and six checks had been paid, and so when these checks were paid there were good balances to United's credit.

The facts, therefore, are that the balances to United's credit on November 12th and 15th when the four and six checks were paid were mainly the proceeds of loans made by plaintiff to United; that when the Lofendo checks were not paid the indebtedness

of United to Merchandise on account of which they had been applied was restored, and United had a right to offset the balance to United's credit against this indebtedness, but that this right was not exercised until after November 15th after the four and six checks were paid; and that consequently the balances to United's credit when these checks were paid were good, not merely apparent, balances.

When Merchandise made its loan to United and took the latter's notes, United was bound by the notes, and Merchandise had the right either to affirm the transactions and hold United liable on the notes or to disaffirm the transaction on the ground of fraud and sue to recover the amounts lent. In other words, the loans were voidable, not void; and until Merchandise disaffirmed the loans, it could not say that the crediting of their proceeds to United's account created an apparent and not a real balance in United's favor.

Assuming for the sake of argument that Merchandise did not know what was going on, its mistake was not in charging the checks against apparent balances, but in believing that the transactions on which it based its loans to United were bona fide when in fact they were part of the kite.

But we say again that if it be assumed that the credits against which the four and six checks were charged were apparent and not good balances, nevertheless under the law these checks were paid and the trial court's findings that they were not is without any doubt erroneous.

B. UPON MERCHANDISE'S PAYMENT OF THE CHECKS THE AGENCY OF BOTH BANK OF AMERICA AND MERCHANDISE FOR THEIR COLLECTION TERMINATED, AND MERCHANDISE THEREUPON BECAME INDEBTED TO BANK OF AMERICA AND BANK OF AMERICA TO LOFENDO IN THE AMOUNTS OF THE CHECKS.

The question whether a bank takes title to paper deposited with it or whether it becomes the agent of the depositor for collection is a question of intention. Where a bank gives its depositor an absolute credit it is presumed, unless a contrary intent is shown, that it has taken title; but when a bank gives its depositor a provisional credit subject to charge back if not collected, it is presumed, unless a contrary intent is shown, that it has not taken title but is an agent for collection. And when a bank does not give its depositor any sort of credit but sends the paper forward for collection, it does not take title but is an agent for collection. See 9 C.J.S., 472-475.

When, therefore, Bank of America, upon the deposit of the four and six checks with it, sent them forward for collection, it did not take title to the checks, but became Lofendo's agent for their collection.

Prior to the adoption of section 16c of the California Bank Act (Act 652 of Deering's California laws) the law of California appeared to be in accord with the so-called Massachusetts rule. *Davis v. First National Bank of Fresno,* 118 Cal. 600, 50 F. 666; *San Francisco National Bank v. American National Bank,* 5 Cal. App. 408, 90 P. 558; and *Nicholetti v. Bank of Los Banos,* 190 Cal. 637, 214 P. 51.

Section 16c provided that a bank allowing a provisional credit for a check should not be liable in the event of the insolvency or other default of any bank handling its collection. The adoption of this statute confirmed the Massachusetts rule as the law of this state so far as checks for which provisional credit has been allowed are concerned.

In brief, the Massachusetts rule is that the collecting bank is not the agent of the forwarding bank for the collection of the check, but the subagent of the depositor.[10]

It follows that defendant was the agent of Lofendo for the collection of the checks and that plaintiff was Lofendo's subagent for this purpose.

In handling a collection a forwarding bank can instruct the collecting bank to collect and remit, or to collect and credit. When the forwarding bank instructs the collecting bank to collect and remit, there is a conflict in the authorities respecting the result. Some cases, like *Hecker-Jones Jewell Milling Co. v. Cosmopolitan Trust Co.,* 242 Mass. 181, 136 N.E. 333, hold that when a forwarding bank instructs a collecting bank to collect and remit and the collecting bank collects by charging the check against the account of

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[10]The difference between the Massachusetts rule and the New York rule is that under the New York rule the collecting bank is the agent of the forwarding bank and not the subagent of the depositor and therefore the forwarding bank is not liable for the negligence of the collecting bank; whereas under the Massachusetts rule, as the collecting bank is the subagent of the depositor, the forwarding bank is not liable for its negligence, provided it has been selected with due care. 9 *C. J. S.* 482-484, sec. 228b and sec. 230a.

the drawer, it becomes the owner of the proceeds and the relation between it and the owner of the check ceases to be that of agent to principal and becomes that of debtor and creditor and the proceeds cannot be impressed with a trust on the theory that the collecting bank continues to hold them as agent. The theory of such cases is that when the instructions are to collect and remit the owner of the check by using banks to make the collection impliedly contracts that the collecting bank in accordance with well known usages may mingle the proceeds of the collection with its own funds and become the owner of them and that when it charges the account of the drawer, it merely reduces its debt to the drawer and increases its own assets by means of book entries and so obtains no res which can be regarded as the subject matter of a trust.

Other cases, like *People v. People's Bank of Rockford,* 353 Ill. 479, 187 N.E. 522 (a case on which plaintiff relied strongly in the trial court), hold that when the forwarding bank instructs the collecting bank to collect and remit, the collecting bank after charging the account of the drawer continues to hold the proceeds of the collection as the agent of the owner of the check and that therefore such proceeds while in its hands can be impressed with a trust. The theory of such cases is that when the instructions are to collect and remit it cannot be assumed that the owner of the check acting through his agent, the forwarding bank, had any intention of becoming a depositor, that is a creditor, of the collecting bank; that

therefore the law should not compel him to take that position; and that when the collecting bank charges the check against the drawer's account, it becomes the holder of a res upon which a trust may be impressed in the same manner as though the owner of the check had withdrawn the currency and handed it back with instructions to remit.

In *People v. People's Bank* just cited the court expressly stated that if the instructions had been to collect and remit by the collecting bank's own check, or if there had been reciprocal accounts between the forwarding and collecting bank, it would have reached the opposite result. The reason for this dictum is obvious. If the instructions are to remit by the bank's own check or if there are reciprocal accounts, the collecting bank upon charging the check against the account of the drawer becomes the owner of the fund and therefore takes the position of a debtor and there is nothing upon which a trust may be impressed.

A discussion of the conflict in the cases to which we have just referred and a citation of the cases on both sides appears in 9 *C.J.S.* 508-510, section 248b.

However, there is no conflict in the cases when the instructions of the forwarding bank are to collect and credit.

When there are reciprocal accounts and the instructions are to collect and credit, there can be no doubt that the intent is that the collecting bank upon charg-

ing the check against the account of the drawer is to become the owner of the funds and is to become a debtor. And so the cases involving reciprocal accounts without exception hold that when the collecting bank collects the check by charging it against the account of the drawer, thereupon the agency of the forwarding bank and the subagency of the collecting bank for the collection of the check terminate and the collecting bank becomes the debtor of the forwarding bank and the forwarding bank of its depositor for the amount of the check. (*Dean Tobacco Warehouse Co. v. American National Bank,* 123 Tenn. 365, 117 S.W. (2d) 746; *Maget v. Bartlett Bros. Land and Loan Co.,* 226 Mo. App. 416, 41 S.W. (2d) 849; *Storing v. First National Bank,* 8th Cir., 28 F. (2d) 587; *Rickey v. New York State National Bank,* D.C. N.D. N.Y., 7 Fed. Supp. 29 (the decision was affirmed without opinion in 70 F. (2d) 1020, 2d Cir.); and *First National Bank of Richmond v. Davis,* 114 N.C. 343, 19 S.E. 280.

In *Dean Tobacco Warehouse Co. v. American National Bank* just cited, the court quoted from 9 *C.J.S.* 497 as follows:

> "'There are two usual methods of handling items forwarded for collection; that of reciprocal accounts and that of remittance. Under the reciprocal accounts method the collecting bank on receipt of payment of the item, gives credit on its books to the forwarding bank and the forwarding bank charges the collecting bank on its

books, the banks settling from time to time with the one or the other in accordance with the accumulated balance. Under the remittance method the forwarding bank sends the item to the collecting bank with instructions to collect and remit immediately. Under the reciprocal accounts method the relation of the banks is that of creditor and debtor. Under the remittance method the collecting bank is not authorized to retain the proceeds in its hands and therefore acts only as an agent for the forwarding bank.'"

The same result is reached when there are not reciprocal accounts between the forwarding and collecting banks and the instructions of the forwarding bank are to collect and credit; that is in such a case the agency of the forwarding bank and the subagency of the collecting bank terminate upon the collection of the check by the charging of it against the account of the drawer and the crediting of the forwarding bank, and therefore the collecting bank becomes indebted to the forwarding bank and the forwarding bank to the depositor in the amount of the check. *Hekler v. Ward,* D.C. E.D. Penn., 21 F. Supp. 710; *People ex rel. Nelson v. Sheridan Trust and Savings Bank,* 358 Ill. 290, 193 N.E. 186; *First National Bank of Corsicana v. Cameron & Co.,* 149 S.W. (2d) 132.

In *People ex rel. Nelson v. Sheridan Trust and Savings Bank,* just cited, the court said:

"Until the time that the check was collected, the candy company could have revoked the agency,

> but when the payment of the check was made, at the close of the business day on which the check was collected, the purpose of the agency had been completed and the relation of debtor and creditor was fixed between the parties * * * The Sheridan bank could not then, nor could any intermediate bank participating in the collection of the check, rescind its action, nor could any of the banks deny the existence of the unconditional credit to the funds entered upon their respective books of account."

Therefore, so far as this phase of the case is concerned, if defendant's instructions to plaintiff were to collect and credit rather than to collect and remit, that fact decisively establishes that Merchandise upon the payment of the checks became the debtor of Bank of America and Bank of America the debtor of Lofendo.

It was stipulated that the collection letter sent by Bank of America to Merchandise with the four checks was dated November 10th and was in the same form as the collection letter sent by Bank of America accompanying the six checks which was introduced in evidence as defendant's exhibit G (I, 302-303). The collection letter accompanying the six checks is reproduced on page 1268 of the record. It was addressed to Merchandise and stated that the items "described below [the six checks] were enclosed for collection." It then provided "Please make separate remittance or credit for this collection as indicated below." The

letter then stated "please dispose of all proceeds as indicated by letter 'K' ". The letter "K" reads as follows:

> "K. Credit Bank of America N. T. & S. A. with advice to this branch."

The four advices of credit relating to the four checks (deft's. ex. J) are reproduced on pages 1269-1270 of the record. There is printed on each of them the following three sentences with a dotted line before each sentence:

> ".....We inclose our check in payment.
>
> .....We credit your account with total shown above.
>
> .....We return the above-described item unpaid."

Merchandise by checking the second sentence on each advice of credit informed Bank of America that it had followed the instructions of the collection letter by crediting Bank of America's account.

The one advice of credit relating to the six checks (deft's. ex. A) appears on page 94 of the record. It is in the same form as the other advices. And Merchandise by checking the second sentence on the instrument informed Bank of America that it had followed the instructions of the collection letter by crediting Bank of America's account.

During 1948 Merchandise had sums on deposit with Bank of America (I, 175). The ledger sheet of Mer-

chandise's account with Bank of America was introduced in evidence as plaintiff's exhibit 1. It shows that the four checks were charged against Merchandise's account on November 18th and the six checks on November 19th.

Bank of America did not keep money on deposit with Merchandise; but Merchandise kept an account of its transactions with Bank of America. The ledger sheet of this account was introduced in evidence as defendant's exhibit H. It shows that Merchandise credited Bank of America with the amount of the four checks on November 12th and with the amount of the six checks on November 15th.

Messenger testified that defendant's exhibit H was "an internal document" used by Merchandise to record the transactions between it and Bank of America and that no copy, transcript or statement of it was ever sent Bank of America (I, 312-313). Later he testified that Merchandise kept exhibit H to show the balances which Bank of America owed it and that therefore Merchandise entered on exhibit H in the ordinary course of business debits in its favor and credits in favor of Bank of America (I, 322-323).

The fact that Bank of America did not have money on deposit with Merchandise does not mean that the accounts between them were not reciprocal. Nor does the fact that Merchandise did not send Bank of America statements drawn off its account mean this. 1 Cal. Jur. 143-144, sec. 4, says:

> "Mutual accounts are made up of matters of setoff, where there is a debt on one side which constitutes a credit on the other, or where there is an express or implied understanding that mutual debts shall be satisfied or setoff pro tanto between the parties."

Webster's New International Dictionary defines mutual as "reciprocally acting or related". The transactions between the two banks were "matters of setoff"; a credit given by Merchandise to Bank of America was a charge by Bank of America against Merchandise. Their accounts were, therefore, mutual or reciprocal.

It thus appears that the instructions given by Bank of America collection letters were that Merchandise should collect and credit; that Merchandise followed these instructions and informed Bank of America by the advices that it had done so. It is also true that the accounts between the banks were reciprocal.

It follows indubitably, in the light of the cases cited above, that when Merchandise debited the four and six checks to United's account and credited defendant, the agency of Bank of America and the subagency of Merchandise for the collection of the checks thereupon terminated and Merchandise became the owner of the proceeds of the checks and became indebted to Bank of America and Bank of America became indebted to Lofendo in the amount of the checks.

And we should add that under these authorities the result would have been the same if there had not been reciprocal accounts between the two banks, but the instructions of Bank of America had been what they were, that is that Merchandise should collect and credit.

C. STATEMENT OF RELEVANT FACTS RELATING TO LOFENDO ACCOUNT.

Points D to and including G of this brief must be decided on the basis of these facts. As this is so we will state them here in full and then in our discussion of these points refer to such of them as are relevant.

We should have in mind the stipulation already mentioned with respect to the practice of both Merchandise and Bank of America in posting in-clearings and counter work; the former were preposted, and there was delayed posting of the latter.

The following statement is based mainly on the written stipulation marked plaintiff's exhibit 14 (IV, 1175-1183). Those facts in it not appearing in this stipulation will be supported by citation of the record.

At the close of business at the Branch on November 10, 1948, there was a balance to the credit of Lofendo of $13,061.17, all in collected funds. On November 15th checks of Lofendo drawn on his account totalling

$75,586.86 were received at the Branch in the inclearings. $51,862.36 of these checks were payable to United (II, 771-773). The checks payable to United were Lofendo checks received as remittances by Merchandise and applied by it on account of United's indebtedness to it. (See remittance sheet of November 6th, part of deft's. ex. FF; and deft's. exs. JJ and KK, sheets from the note liability ledger and assigned accounts receivable ledger kept by Merchandise to show United's indebtedness to it and the collateral therefor.) When the Branch paid these checks United's indebtedness to Merchandise was reduced; and so Merchandise got the benefit of the payment.

As on November 15th, when the checks for $75,586.86 were received at the Branch there was only a balance of $13,061.17 to Lofendo's credit, there were insufficient funds in the account to pay them. When the $75,586.86 was received on November 15th, the Branch under section 16c of the California Bank Act had until the end of the next succeeding business day to reject them. But it did not reject them, and so under the law it in effect paid them although it had not charged them against any credit in the account.

On November 15th checks for $97,207.00 drawn by United on Merchandise to the order of Lofendo were received at the Branch in the mail; and, pursuant to the practice of delayed posting, the Branch on November 16th gave Lofendo immediate credit for this $97,207.00 as of the 15th. Estribou, the Branch's man-

ager, testified that the giving of this credit to Lofendo was contrary to his instructions and a mistake (I, 374-375). But, of course, Bank of America was bound by the act of its clerk in allowing Lofendo this credit.

On November 15th, the Branch forwarded these checks for $97,207.00 to the Continental Illinois Trust Company in Chicago so that it could collect them from Merchandise through the Chicago Clearing House.

On November 16th there arrived in the Branch in the in-clearings three checks for $109,569.15. These checks aggregating $109,569.15 were likewise payable to United (II, 771-773), and were Lofendo checks which had been received as remittances by Merchandise and applied by it on account of United's indebtedness to it (see remittance sheets of November 8th and 9th, part of deft's. ex. FF, and said deft's. exs. JJ and KK). When the Branch paid these checks United's indebtedness to Merchandise was reduced; and so Merchandise got the benefit of the payment.

As stated, the Branch had until the close of business on November 16th, within which to reject the checks for $75,586.86; and as also stated, it did not reject them. And the Branch had until the close of business on November 17th within which to reject the checks for $109,569.15. And so on November 16th the Branch had in its hands checks of Lofendo drawn

on the account aggregating $185,156.01 (the checks for $75,586.86 plus the checks for $109,569.15); and at that time there was to the credit of Lofendo the $13,061.17 of collected funds, plus the credit for the checks of $97,207.00 which were uncollected.

The Branch did not reject either the checks for $75,586.86, or the checks for $109,569.15; but on November 16th it debited the checks for $109,569.15 against the amount of the credits then in the account, that is, $110,268.17 (the credits of $13,061.17 of collected funds and of $97,207.00 of uncollected funds). As the credit for $97,207.00 was uncollected, the Branch paid $96,507.98 of the checks for $109,569.15 against uncollected funds; and when it did so Lofendo in effect had overdrawn his account, and so had become indebted to Bank of America in the sum of $96,507.98.

Pursuant to the practice of delayed posting of counter work the credit of $97,207.00 was posted on November 16th as of November 15th; and pursuant to the practice of preposting in-clearings the debit of the checks for $109,569.15 was made on November 16th, the date of the receipt of these checks, as of November 15th. The result was that the ledger sheet of Lofendo's account shows that as of the close of business on November 15th the balance to the credit of Lofendo was $699.02.

And so at the close of business on November 16th Lofendo had a credit balance of $699.02, and he was

indebted to the Branch in the sum of $75,586.86 (that is, in the amount of the checks which the Branch could have rejected up to the close of business on that day but did not reject) plus the $96,507.98 drawn by him against uncollected funds, a total indebtedness of $172,094.84.

On November 16th there arrived at the Branch the advices of credit stating that the four checks for $89,813.10 had been paid. This amount was credited to the account on November 17th. Pursuant to the practice of delayed posting this credit was actually posted on the 18th as of the 17th. When this credit was entered there was created on the books of the Branch a credit balance in Lofendo's favor of $90,-512.12 (the $89,813.10 plus the credit balance at the close of business on November 15th of $699.02). Concurrently with the entering on the books of the credit for $89,813.10, the checks for $75,586.86 were charged against the account. The result, as shown by the ledger card of the account, was that the credit balance to the account as of the close of business on November 17th was $14,925.26. Although the account showed this credit balance as of the close of business on November 17th, the checks for $97,207.00 had not been paid as of that day, and so at the close of business on that day Lofendo was in fact indebted to the Branch in the difference between $97,207.00 and the credit balance of $14,925.26, or in the sum of $82,-281.74.

In the late afternoon of November 18th, the Branch received a wire from the Continental Illinois that Merchandise had rejected the checks for $97,207.00; and so on that day it was established that Lofendo's indebtedness to the Branch in the sum of $82,281.74 would not be satisfied by the collection of the checks for $97,207.00.

On November 19th, the advice of credit for the six checks for $113,216.50 was received at the Branch; and on that day the account was credited with this amount; and on the same day the account was debited with the $97,207.00. Pursuant to the practice of delayed posting, these last entries were made on November 20th as of November 19th, and so the ledger card shows that at the close of business on November 19th, there was a balance to Lofendo's credit of $30,934.76 (the credit balance as of the close of business on November 17th of $14,925.26, plus the $113,216.50, less the $97,207.00).

D. BANK OF AMERICA HAD A LIEN UPON THE PROCEEDS OF THE FOUR AND SIX CHECKS AND THEREFORE MERCHANDISE IS PRECLUDED FROM RECOVERING ITS PAYMENTS OF THE CHECKS.

It will be recalled that the four checks were collected and paid on November 12th and the six checks on November 15th; that at the close of business on November 16th the Branch had in its hands the advices of credit with respect to the four checks, and at that time the advice of credit with respect to the six checks was in the mail addressed to Bank of America, Merchandise having mailed it on November 15th; and that at the close of business on November 16th Lofendo was indebted to the Branch in the sum of $172,094.84.

The legal consequences of these circumstances are these: Bank of America on November 16th, prior to its receiving any notice of Merchandise's claim, acquired a lien on the proceeds of the checks to secure Lofendo's indebtedness to it. Bank of America, upon becoming entitled to this lien, became a holder for value of such proceeds. Or if Bank of America did not become such a holder, it became a bona fide purchaser of a right to set off such proceeds against the indebtedness due it, a right in the nature of a lien. As Bank of America was such holder or bona fide purchaser, Merchandise is precluded from recovering its payments of the checks.

Section 3054 of the California Civil Code provides:

> "A banker has a general lien, dependent on possession, upon all property in his hands be-

> longing to a customer, for the balance due to him from such customer in the course of the business."

The lien allowed a bank under this section secures any indebtedness due it by a customer, including overdrafts. (*Bromberg v. Bank of America,* 58 Cal. App. (2d) 1, 135 P. (2d) 689.)

Merchandise contends that a banker's lien under Section 3054 is dependent on possession; that under the Massachusetts rule prevailing in California, Merchandise was not Bank of America's agent for collection, but Lofendo's; that therefore Merchandise's possession of the checks was not Bank of America's; and that as Bank of America gave up its possession when it sent them forward for collection, it thereupon lost its lien upon them.

Kane v. First National Bank, 5th Cir., 56 Fed. (2d) 534, and the case of *Goggin v. Bank of America,* 183 Fed. (2d) 322, recently decided by this circuit, directly overrule this contention.

In the *Kane* case the Court, in holding that a bank had a banker's lien on checks deposited with it for collection and did not receive a voidable preference by offsetting prior to bankruptcy their proceeds against an indebtedness due it by the bankrupt, said at pages 537-538:

> "The contract was one for collection and credit: that is to say, the bank, though taking legal title to the checks by indorsement, was only an agent for the depositor, who remained the owner until

> by actual collection the bank became liable to the depositor as for a general deposit, the proceeds becoming at the same moment the property of the bank. [Citing cases.] * * * The banker's lien extends not only to the application of moneys and cash balances, but to the retention and collection of commercial paper and securities which have come into the banker's hands in the ordinary course of business and with no agreement to the contrary. * * * The lien of course survives the customer's insolvency. * * * We do not think the sending of the checks to correspondents for whose diligence and fidelity the bank was agreed not to be responsible waived the lien. The agreement was but a statement of the Massachusetts rule of liability in respect of out-of-town checks taken for collection * * * which rule is of force in Texas without a special agreement. * * * The banker, though he acts under the Massachusetts rule of liability, does not waive his lien by proceeding to collect in the usual way. Although technically the collecting bank is the agent of the depositor, they are actually unknown to one another. The forwarding bank has practical control of the collection, is expected to receive the proceeds, and ordinarily does receive them. * * *"

In the *Goggin* case, the court held that the bank, by virtue of section 3054, had a lien on checks deposited with it for collection and that therefore it could apply the amount collected by it after bankruptcy on account of the checks to the payment of an indebtedness due it by the bankrupt. The court, citing the *Kane* case, said at pages 325-326:

> "It seems to us that the banker's lien clearly was intended to apply to this type of situation. * * * The appellee Bank at the 'date of cleavage,' that is, when the bankruptcy proceedings were commenced and before collection of the commercial paper proceeds of which the receiver here claims, held such paper as agent of Salsbury [the bankrupt], the owner thereof. We conclude that as of that time the Bank had a lien by operation of Section 3054 of the California Civil Code, and that neither the bankruptcy proceedings nor the attempt to terminate the agency could affect such lien."

There can be no doubt, therefore, that under section 3054 a bank has a lien on checks deposited with it for collection and that it does not surrender this lien by forwarding them for collection. If it were held that a bank surrendered its lien on collection item in this way, it would be completely illusory to say that the bank had a lien on them at all.

In *Gonsalves v. Bank of America,* 16 Cal. (2d) 169, 105 P. (2d) 118, the court drew a distinction relevant here between a bank's lien on securities and its right to offset. The court said at pages 173-174:

> "The banker's lien described in this statute [section 3054] is, properly speaking, a lien on the securities such as commercial paper deposited with the bank by the customer in the course of business. The so-called 'lien' of the bank on the depositor's account or funds on deposit is not technically a lien, for the bank is the owner of the funds and the debtor of the depositor, and

> the bank cannot have a lien on its own property. The right of the bank to charge the depositor's fund with his matured indebtedness is more correctly termed a right of setoff, based upon general principles of equity * * *
>
> * * * despite the technical inaccuracy involved in calling it a lien, it is in the nature of a lien or security interest in the funds, similar to and enforceable in the same way as the lien against commercial paper. That is to say, it is enforceable by the bank's own act, without the aid of a court."

And so when a bank collects a check, it ceases to have a technical lien on the check, but it then acquires a right of setoff which is "in the nature of a lien or security interest in the fund."

When on November 12th and 15th Merchandise paid the four and six checks Lofendo was not indebted to Bank of America. He did not become indebted to Bank of America until the close of business on November 16th. A bank, of course, does not have a banker's lien under section 3054 on a depositor's securities unless the depositor is indebted to it. And so, as Lofendo did not become indebted to Bank of America until after the checks were paid, Bank of America never did have a lien on the checks themselves, but at the close of business on November 16th it had a right to offset the credit to which Lofendo became entitled on the payment of the checks against Lofendo's indebtedness to it, which right was in the

nature of a lien or security interest in the fund created by Merchandise's payment of the checks.

Section 3108 of the California Civil Code (section 27 of the Negotiable Instruments Act) provides:

> "Where the holder has a lien on the instrument, arising either from contract or by implication of law, he is deemed a holder for value to the extent of his lien."

If Bank of America prior to receiving notice of Merchandise's claim had acquired a lien on the checks themselves and had therefore become under this section a holder for value, Merchandise in that event could not have recovered the payments. Restatement, Restitution, section 33. According to our understanding, Merchandise does not controvert this proposition and so we will not dwell on it.

Merchandise, however, argues that as the checks were paid prior to Lofendo becoming indebted to the Bank and as therefore Bank of America did not acquire a lien on the checks themselves, it cannot be regarded as a holder for value under section 3108.

Bank of America's answer is that you cannot separate in this way a negotiable instrument from its proceeds; that the main purpose of the negotiable instruments law is to protect the holder of such an instrument so that he will receive its proceeds free of any equities; and that it if were held that one who does not acquire a lien on an instrument itself, but does acquire a lien on the fund created by its pay-

ment, is not a holder for value, this main purpose of the law would be defeated.

Bank of America has not been able to discover any authority dealing with the point; and so far as we know, neither has Merchandise. It is submitted that as Merchandise's view would impair the negotiable character of commercial paper, but Bank of America's view would preserve and promote that character, the latter should be accepted.

But assuming, for argument's sake, that Bank of America did not become a holder for value under section 3108, nevertheless Bank of America did become a bona fide purchaser for value of its right of setoff, or lien, whichever one wishes to call it; and therefore Merchandise is not entitled to recover the payments.

Section 14 of the Restatement of the Law of Restitution says (p. 55):

> "(1) A creditor of another or one having a lien on another's property who has received from a third person any benefit in discharge of the debt or lien, is under no duty to make restitution therefor, although the discharge was given by mistake of the transferor as to his interests or duties, if the transferee made no misrepresentation and did not have notice of the transferor's mistake.
>
> *Comment:*
>
> a. The rule stated in this section is a specific application of the underlying principle of bona fide purchase. Comment a on section 13 is applicable."

Comment a on Section 13 says in part:

> "a. The principle that a person who innocently has acquired the title to something for which he has paid value is under no duty to restore it to one who would be entitled to reclaim it if the one receiving it had not been innocent or had not obtained the title or had not paid value therefor, is of wide application, being a limitation upon the principle that a person who has been wrongly deprived of his things is entitled to restitution. This limitation involves no moral issue, since it merely creates convenient rules for determining which of two innocent persons should bear a loss which must be borne by someone."

The law, therefore, is that where a creditor receives on account of the obligation due him a benefit from a third person without having notice that the benefit was conferred by mistake, the creditor has the right to retain it; he has the title and he received it without notice and so he is in the position of a bona fide purchaser.

We refer the court particularly to all the illuminating illustrations to section 14 (pp. 57-58). We quote one of them as follows:

> "6. A steals an automobile and mortgages it to B who lends him $500 thereon. A then borrows $700 from C telling C of B's mortgage. In accordance with his agreement with A, C pays B $500 to discharge B's mortgage and gives A $200, taking a mortgage for $700. The owner of the car reclaims it. C is not entitled to restitution from B."

This is very like the recent case of *Hilliard v. Bank of America,* 102 Cal. App. (2d) 730, 228 P. (2d) 327, in which a hearing was denied b y the California Supreme Court. The California Supreme Court has accepted the restatement as decisive even when in conflict with its own prior decisions. *Speck v. Wylie,* 1 Cal. (2d) 625, 36 P. (2d) 618. But if it were necessary to show by citation that the California courts have approved the rule of the restatement quoted above, the *Hilliard* case would suffice.

The case at bar falls exactly within the rule of the restatement. When on November 16th Lofendo became indebted to Bank of America, it thereupon prior to receiving notice of Merchandise's claim acquired its right of setoff or lien on the fund created by Merchandise's payment of the checks. It can no more be deprived of this right or lien by thereafter learning that Merchandise conferred the benefit by mistake than a creditor to whom machinery has been mortgaged to secure the obligation due him can be deprived of his mortgage upon learning after the mortgage has been consummated that the person from whom his debtor obtained title to the mortgaged property claims the right to set aside the transfer on the ground of fraud or mistake.

Even if Bank of America was not a holder for value under section 3108, it was a bona fide purchaser of its right of setoff or lien, and therefore Merchandise cannot recover its payments.

E. MERCHANDISE CANNOT RECOVER FROM BANK OF AMERICA ITS PAYMENT OF THE FOUR AND SIX CHECKS BECAUSE IT RECEIVED A SUBSTANTIAL BENEFIT FROM THEIR PAYMENT.

70 *C. J. S.* 368 states the applicable rule as follows:

> "The rule permitting recovery of payments made under mistake of fact is not necessarily applicable in all circumstances. Since the rule is founded on considerations of equity and good conscience, there can be no recovery of a payment from which the payor has received a substantial benefit, or which the payee has received in good faith and may in good conscience retain."

It will be recalled that there was charged against the credit for the four checks of $89,813.10 the checks for $75,586.86; and that there was included in these checks for $75,586.86 checks for $51,862.36 drawn by Lofendo on the Branch and payable to United and delivered by United to Merchandise as remittances on account of assigned accounts receivable and applied by Merchandise on account of United's indebtedness to it. When United's indebtedness to Merchandise was reduced by this $51,862.36, it got the benefit of the charging of these checks against the $89,813.10. And so if Merchandise recovers the $89,813.10, it will in effect have been paid twice; once when it got the benefit of the checks charged against this $89,813.10 and again when it recovers this amount. Under the rule just cited, this inequitable and unconscionable result precludes a recovery by Merchandise of its payment of the four checks.

On the same ground Merchandise is precluded from recovering its payment of the six checks. It will be recalled that the checks for $109,569.15 drawn by Lofendo on his account with the Branch were charged against the checks for $97,207.00 drawn by United on its account with Merchandise and credited by the Branch to Lofendo's account; that when the checks for $97,207.00 were presented to Merchandise for payment, Merchandise rejected them; that then the $97,-207.00 was charged against the credit for the six checks of $113,216.50; and that the Lofendo checks for $109,569.15 were delivered by United to Merchandise as remittances on account of assigned accounts receivable and were applied by Merchandise on account of United's indebtedness to it. When United's indebtedness was reduced by this payment, Merchandise got the benefit of it. If Merchandise is permitted to have the $109,569.15 charged against the $97,207.00 and at the same time to recover the $113,216.50 against which the $97,207.00 was charged, it will be getting the benefit of the $97,207.00 disbursed by Bank of America and at the same time will be denying Bank of America the benefit of its payment of the six checks. Under the law this inequitable and unconscionable result precludes Merchandise from recovering its payment of the six checks.

Merchandise's answer to this argument is that it was a holder in due course of the checks for $51,862.36, which were charged against the credit of the four checks, and of the checks for $109,569.15 which were

in effect charged against the credit of the six checks; that as such holder it was entitled to the payment of these checks; and that when Bank of America makes the contention under discussion it is in effect claiming that it is entitled to recover its payment of them.

The argument is entirely specious. In this action Merchandise is not suing as a holder in due course to enforce the payment of a check. Nor is Bank of America endeavoring to recover the payment of checks paid by it. But Merchandise is suing to recover its payments of the four and six checks on the ground that it was induced to pay them by mistake. Under the law it cannot maintain the action if it received a substantial benefit from the payments and therefore is not in equity and good conscience entitled to recover them. In deciding the point, one should not consider each check as though it were an isolated transaction, but one should consider all the circumstances to determine whether in fact and reality Merchandise did secure a substantial benefit from its payment of the four and six checks. As such circumstances show that it did, it cannot under the law recover.

F. BANK OF AMERICA'S POSITION WAS CHANGED BY REASON OF MERCHANDISE'S PAYMENT OF THE FOUR CHECKS AND THEREFORE IT BECAME A BONA FIDE PURCHASER OF THEIR PAYMENT.

It will be recalled that the trial court found that when on November 17th the Branch received notice that United had defrauded Merchandise it had not

changed its position in reliance on Merchandise's payment of these checks and that therefore it did not become a bona fide purchaser of the payments.

Merchandise maintains that this finding is supported by *Weiner v. Roof,* 19 Cal. (2d) 748, 122 P. (2d) 896. Bank of America contends that it is contrary to the law laid down by that case.

In the *Weiner* case Connolly contracted to sell Roof a parcel of land so that Roof could subdivide it. They created a subdivision trust under which the Citizens Bank was the trustee and agent to receive the purchase price of lots and to apply such payments to the expenses of the trust and then to the payment of the amount due Connolly and to pay the remaining balance to Roof. Weiner, after having been induced by fraud to purchase a lot, rescinded the sale and sought to recover from the Citizens Bank the amount he had paid it on account of the price. The Bank, before Weiner rescinded the sale, had applied what Weiner had paid it to the expenses of the trust and on account of an indebtedness due it by Connolly. The court held that the Bank's position had been changed by the payment; that it was, therefore, in the position of a bona fide purchaser; and that consequently Weiner could not recover the payment.

Merchandise claims that Bank of America held the payment of the proceeds of the four checks as the agent of Lofendo; that it did not act in reliance on the payment until November 18th when it posted the credit for the four checks to the Lofendo account; and that consequently under the rule of the *Weiner*

case its position was not changed by the payment and it did not become a bona fide purchaser.

Bank of America has several answers to this contention.

(a) In the first place the evidence shows without conflict that when on November 18th Bank of America posted the credit of the four checks, it had received no notice of Merchandise's claim with respect to the payment of these checks.

The trial court found that on November 17th and on November 18th Merchandise informed Bank of America that United had defrauded Merchandise of a large sum of money exceeding $500,000 and had done so by means of fictitious and fraudulent checks drawn on the Lofendo account, and that consequently Bank of America did not become a bona fide purchaser of the payment of the four checks (I, 111). The finding is not supported by the evidence. Messenger testified that in his telephone conversation with Estribou of November 17th, he told Estribou that United had perpetrated a fraud on Merchandise and that one of its officers had admitted that it had pledged fraudulent accounts receivable to Merchandise (I, 220-221); that he had a list of checks received from Lofendo and wanted to ascertain whether or not any of these checks had been paid (I, 221); and that the advice of credit for the six checks had been sent out in error (I, 223). The rest of the conversation related to this advice of credit and other incidental matters not at all relevant here (I, 223-225).

LeRoy testified that in his conversation with Duncan of November 18th he told Duncan that Merchandise had been swindled and had suffered a heavy loss in its transaction with United (II, 480, 481); and that he had with him a list of Lofendo checks, the fate of which he wanted to determine (II, 483-484). The remainder of his conversations with Duncan and with Duncan and Johnson related to the advice of credit for the six checks and other matters not relevant here (II, 448-461, 482-497).

Messenger did not tell Estribou and LeRoy did not tell Duncan and Johnson that as found by the court United had defrauded Merchandise "by means of fictitious and fraudulent checks drawn on the Lofendo account." Messenger's explanation to Estribou of the fraud was that an officer of United had told Merchandise that United had pledged to Merchandise fictitious collateral. LeRoy did not explain to Duncan or Johnson how United had "swindled" Merchandise. It is true that both Messenger and LeRoy wanted to determine the date of the Lofendo checks; but in the conversations neither of them stated how Merchandise had received these checks, and neither of them said that Merchandise had been defrauded "by means of fictitious and fraudulent" Lofendo checks.

But if they said this, what difference would it make? The question here is not whether Messenger or LeRoy gave Bank of America notice that the checks drawn on the Lofendo account were fictitious, but whether either of them gave defendant notice that

Merchandise had made a mistake in paying the four checks. And neither of them did. The four checks were not mentioned in the conversations.

Merchandise's idea that it would recover its payment of the four checks from Bank of America was an afterthought. This is demonstrated by the fact that it did not even seek to recover this payment in this action until the very end of the trial when it obtained leave of court to amend its complaint to include a demand for the payment.

The statements of Messenger and LeRoy that United had defrauded Merchandise were entirely consistent with the fact that Merchandise had not made any mistake in paying the four checks. Merchandise itself thought so because, as just stated, it made no claim with respect to the four checks until the end of the trial.

Merchandise's contention is that Bank of America did not act in reliance on the payment of the four checks until it posted the credit on November 18th. Assuming for argument's sake that the contention is sound, the fact is that Bank of America performed those acts before notice of any claim by Merchandise with respect to the four checks; consequently under the rule of the *Weiner* case Bank of America must be regarded as a bona fide purchaser of the payment.

(b) But if it be assumed for argument's sake that in the telephone conversation of November 17th Bank of America received notice of Merchandise's claim with respect to the four checks, and if it also be as-

sumed for the same purpose that under the rule of the *Weiner* case Bank of America in order to become a bona fide purchaser of the payment was required before receiving such notice to take action in reliance on the advices of credit with respect to the four checks, still the record shows that Bank of America did take such action and therefore did become a bona fide purchaser of the payment.

It will be recalled that it was stipulated that both Merchandise and Bank of America posted "in-clearings" as of the day next preceding the day of their presentation, and that it posted counter work (all debits and credits other than in-clearings) "on the next business day after the day on which they were handled, but the posting appeared under the date on which they were actually handled"; in other words, that in-clearings were preposted and there was delayed posting of counter work (III, 960-961).

The stipulation marked plaintiff's exhibit 14 states that the checks for $75,586.86 were received at the Branch in the in-clearings on November 15th and were kept at the Branch until November 17th "when they were put in the counter work" (IV, 1181); that the advices of credit with respect to the four checks for $89,813.10 were received on November 16th (IV, 1182); that this sum was "credited to the account on November 17th" and posted on the 18th and "concurrently the checks for $75,586.86 were charged against the new funds" (IV, 1183).

In short, the facts are these: both the advices of credit for the four checks and the checks for $75,586.86 were handled in the counter work of November 17th. Pursuant to the practice of delayed posting, the credit for the $89,813.10 and the debiting thereto of the checks for $75,586.86 were posted on the 18th; but they were posted on that day as of November 17th, the day on which the banking operation took place. Plaintiff's Exhibit 35, the ledger card of the Lofendo account, shows that both the credit and the debit were posted as of the 17th.

Messenger testified that his telephone conversation with Estribou started at 4:17 P.M. central standard time on November 17th (I, 218-219). It was stipulated that in November of 1948, California was on daylight savings time (I, 219-220). And so in that month Chicago time was one hour, instead of two, ahead of California time. Estribou testified that when the conversation took place, the collection department of the Branch was closed and that therefore he could not tell Messenger definitely whether the advice of credit for the six checks had been paid (I, 396).

It thus appears that the telephone conversation did not occur until hours after the counter work of the day had been started and when it was being brought to an end.

If, as Merchandise contends, Bank of America cannot be held to be a bona fide purchaser of the payment of the four checks until it had acted on the advices of credit, the fact is that the banking operation,

in which the credit was allowed Lofendo and the debit made against it, took place on November 17th before the telephone conversation of that day. When this banking operation took place, Bank of America had certainly acted on the advices of credit. The fact that Bank of America pursuant to the practice of delayed posting did not make the bookkeeping entries until November 18th can make no difference. It is the banking operation itself, not the bookkeeping entries, which must control. The crediting of the four checks on November 17th and the putting of the checks for $75,586.86 in the counter work of that day fixed at the very latest the rights of Lofendo and Bank of America, even if the transaction had never been recorded on the books at all. There is no magic in book entries. The rights of persons cannot be made to depend on whether or not they are made.

In *Briviesca v. Coronado,* 19 Cal. (2d) 244, 120 P. (2d) 649, the court said:

> "The liability of the bank to the depositor payee is not based upon the check or any promise to pay the check, but arises from the relationship of debtor and creditor that exists between a bank and a depositor. (See cases cited in 7 Am. Jur. 313, sec. 444.) In the instant case this relationship came into existence at the time the deposit was made, not at the time the check was stamped and the account posted in the ledger."

In *American Exchange National Bank v. Gregg,* supra (138 Ill. 596, 28 N.E. 839, 841), the court said:

> "Something has been said in regard to the fact that the check given to D. Eggleston & Son had not been actually charged to Kershaw & Co. on the books of the bank until after the check involved was presented and payment demanded. We do not regard this as a controlling element in the case. This was a matter of bookkeeping, and the rights of the parties are not to be determined merely from the manner in which books are kept."

And in *Nineteenth Ward Bank v. First National Bank,* supra (184 Mass. 49, 67 N.E. 670, 671), the court said:

> "It is true that the proper records were to be made upon the books, but the payment is affected by the acts, and not by the record, and was valid even without records. Consequently the question of the subsequent records is not material. So far as respected the plaintiff, the defendant had received the money for the note, and was bound to remit it to the plaintiff."

(c) But under the rule of the *Weiner* case it was not necessary for Bank of America to have acted on the advices of credit by putting them through any banking operation or by entering them on its books in order to become a bona fide purchaser of the payment.

The difference between Merchandise and Bank of America with respect to the rule of that case is this: Merchandise maintains that under its doctrine an agent who is a creditor of his principal can never

become a bona fide purchaser of a payment made to him on his principal's account until he has actually made the bookkeeping entries crediting the principal with the amount of the payment.

Bank of America contends on the other hand that the intention of the parties disclosed by the facts must control; that when the intention is that the agent shall hold the money on behalf of his principal and it is not anticipated that the agent shall not apply it to the payment of any indebtedness the principal might owe him, then there must be some affirmative act of the agent after receiving the payment applying it on account of the principal's indebtedness before the agent will be deemed a bona fide purchaser; but that when the intention is that any payment received by the agent shall be applied on account of the principal's indebtedness to him, then the agent upon receiving the payment and without any additional affirmative act will be deemed a bona fide purchaser.

If Bank of America's position be not sound, then the rights of the parties would depend, not on what was intended, but on a fortuitous circumstance, that is, whether the agent did or did not make bookkeeping entries. This cannot be the law. The fact that it is not the law is shown by the following extract from the Weiner decision (19 Cal. (2d) 748, 754):

> "They [cases theretofore referred to by the court] fail to distinguish between an agent who holds the money on behalf of his principal after crediting it to the principal's account and an

> agent who has received the money, with the consent of the principal, in payment of a debt owed to him by the principal. In the latter situation the agent is in the position of a bona fide purchaser for value; in the former he is not.

When Merchandise paid the four checks on November 12th and credited Bank of America, Merchandise became indebted to Bank of America and Bank of America to Lofendo in the amount of the four checks. Assuming for argument's sake that this is not so, still at the very latest Lofendo became entitled to the credit on November 16th when the advices of credit arrived at the branch. Certainly the Branch could not have said to him on that day, "Yes, we have received the advices that the checks have been paid, but we have not entered the credit on our books and so you are not yet entitled to it." And when Lofendo became entitled to the credit on November 16th, he was, as we have seen, indebted to the Branch in the sum of $172,094.84 on account of overdrafts.

This is not a case in which it was intended that Bank of America should hold payments made to it on account of checks collected by it for Lofendo and not apply such payments to overdrafts in Lofendo's account. But it is a case in which it was intended that Bank of America should *ipso facto* apply any such payments against any such overdrafts; that the debits would be automatically offset by the credits; and that this should take place without regard to

when the bookkeeping entries were made recording the transactions.

It follows that at the close of business on November 16th, before there was even a possibility that Bank of America had received notice of Merchandise's claim with respect to the four checks, the credit for these checks to which Lofendo was entitled on that date was offset by the debits for his overdrafts; and, therefore, under the rule of the *Weiner* case, on that date Bank of America's position was changed by the payment of the four checks and it became a bona fide purchaser of the payment.

(d) The *Weiner* case is just one illustration of a change in a payee's position preventing a recovery of a payment. But any change in a payee's position will have this result. The general rule is stated in 70 *C.J.S.* 372 as follows:

> "In general, where a payee has changed his position to his prejudice in reliance on the payment and cannot be placed in statu quo, the payment cannot be recovered, although made under a mistake of fact; * * *"

As we have seen, when on November 10th Bank of America sent the four checks to Merchandise for collection, it was Lofendo's agent for their collection. But when on November 12th Merchandise paid the checks and credited Bank of America with the payment, Bank of America became a creditor of Merchandise and a debtor of Lofendo in the amount of the payment and Bank of America's agency for the collection of the checks thereupon terminated. There-

fore the making of the payment itself brought about definite and important changes in Bank of America's position. Bank of America, instead of being Lofendo's agent for the collection and payment of the checks, had become the creditor of Merchandise and the debtor of Lofendo in the amount of the payment. In the *Weiner* case, the agency continued after the payment; in this case it terminated upon the payment being made. In the *Weiner* case, the bank which was the agent in that case did not become the creditor of the payor, but received the funds themselves; in this case Bank of America upon the payment being made became a creditor of the payor. There were, therefore, in this case more drastic changes in the payee's position than those involved in the *Weiner* case. It follows that Merchandise under the general rule cannot recover the payment.

(e) Summing up this discussion: Bank of America became a bona fide purchaser of and entitled to retain the payment of the four checks for these reasons: (1) Bank of America received no notice of Merchandise's claim with respect to the four checks until long after November 18th when the bookkeeping entries were made. (2) Although the bookkeeping entries were not made until November 18th, Bank of America had acted in reliance on the payment of the four checks on November 17th, before the telephone conversation of that day, by on that day crediting the four checks to the account and putting the checks for $75,586.86 in the counter work as a charge against the credit. (3) But under the doctrine of the *Weiner*

case it was not necessary for Bank of America to have actually based a banking operation or made bookkeeping entries on the basis of Merchandise's payment of the four checks in order to become a bona fide purchaser of the payment. On November 16th, before there was any possibility that Bank of America had received notice, the credit for the four checks to which Lofendo was entitled on that date was automatically offset by the overdraft in his account even though no bookkeeping entries of the transaction had ever been made; and so under the rule of the *Weiner* case Bank of America became a bona fide purchaser. (4) Bank of America's position was changed because by virtue of Merchandise's payment of the checks Bank of America's agency for their collection was terminated and it became Merchandise's creditor in the amount of the payment.

G. BANK OF AMERICA'S POSITION WAS CHANGED BY REASON OF MERCHANDISE'S PAYMENT OF THE SIX CHECKS AND THEREFORE IT BECAME A BONA FIDE PURCHASER OF THEIR PAYMENT.

The trial court made substantially the same findings with respect to the six checks as its findings with respect to the four, that is, it found that when on November 17th the Branch received notice that United had defrauded Merchandise it had not changed its position in reliance on Merchandise's payment of the six checks, and therefore Bank of America did not become a bona fide purchaser of the payment.

There are differences between Bank of America's position with respect to the four checks and its position with respect to the six. In the telephone conversation of November 17th Messenger did tell Estribou that Merchandise had paid the six checks in error; and the advice of credit with respect to the six checks was not received at the Branch until November 19th and not credited to the account until that day. And so Bank of America cannot make two of the claims with respect to the six checks which it is making with respect to the four, that is, it cannot claim that it did not receive notice of Merchandise's claim with respect to the six checks until long after it had acted on their payment, nor can it claim that it in its banking operations actually took credit for the six checks before the telephone conversation of November 17th.

However, Bank of America did become a bona fide purchaser of the six checks for two of the same reasons that it became such a purchaser of the four, that is, for the same reason discussed in subdivisions (c) and (d) of point F.

(a) When Merchandise paid the six checks on November 15th, it became indebted to Bank of America and Bank of America to Lofendo in the amounts of the payment, and Bank of America's agency for the collection of the checks was then terminated. Assuming for argument's sake that what we have just stated is not so, nevertheless the fact is that Merchandise mailed the advice of credit with respect to the six checks on November 15th. When on that date

Merchandise mailed the instrument, it was delivered to Bank of America and Bank of America in effect became the holder of it. *People v. Larue,* 28 Cal. App. (2d) 748, 753-754, 83 Pac. (2d) 725, 728. When on November 15th Bank of America in this way became the holder of the advice of payment, Lofendo became entitled to the credit. Certainly the Branch could not have said to him on that day, "Yes, the checks have been paid and the advice that they have been paid and that Merchandise National Bank has credited this bank with the amount of payment is in the mail and has therefore been delivered to us, but we have not yet received the advice and have not yet credited it on our books to your account and so you are not entitled to it."

At the close of business on November 16th Lofendo was indebted to Bank of America in the sum of $172,094.84 on account of overdrafts, and when on November 17th Lofendo's account was credited with the $89,813.10 and charged with the $75,586.86, Lofendo remained indebted to the Branch in the sum of $82,281.74.

As pointed out in our discussion of the four checks, this is a case in which it was intended that Bank of America should *ipso facto* apply any credits to which Lofendo should become entitled against his overdrafts, and that this offset should occur whether or not evidenced by bookkeeping entries.

It follows that at the close of business on November 16th, before Bank of America received notice of Merchandise's claim to its payment of the six

checks, the credit for the six checks to which Lofendo was entitled on that date was offset by the debits for his overdrafts; and that, therefore, under the rule of the *Weiner* case, on that date Bank of America's position was changed by the payment of the six checks and it became a bona fide purchaser of the payment.

(b) As in the case of the four checks, the payment by Merchandise of the six checks on November 15th in itself brought about a change in Bank of America's position, because upon the payment being made Bank of America's agency for the collection of the six checks terminated and it became a creditor of Merchandise and a debtor of Lofendo in the amount of the payment. Under the general rule, this change of position on Bank of America's part precludes Merchandise from recovering the payment.

H. MERCHANDISE KNEW OR SHOULD HAVE KNOWN OF THE KITE AND IS THEREFORE PRECLUDED FROM RECOVERING THE PAYMENTS.

1. The trial court's failure to find with respect to the issue whether Merchandise knew or should have known of the kite.

Where a trial court fails to find with respect to a material issue, the judgment must be reversed. *Marlborough Corporation v. United States,* 9 Cir., 172 F. (2d) 787; *Gillis v. Gillette,* 9 Cir., 177 F. (2d) 7; *Cafritz v. Koslow,* Ct. App. D.C., 167 F. (2d) 749; *Dearborn National Casualty Co. v. Consumers Petroleum Co.,* 7 Cir., 164 F. (2d) 332.

The trial court found that no act or omission of Merchandise proximately caused or contributed to any loss sustained by Bank of America (I, 112); but it made no findings respecting the issue raised by the allegations of Bank of America's answer that Merchandise knew or should have known of the kite. Its position was that assuming these allegations to be true, they constituted no defense to the action, and were therefore immaterial, and no findings respecting them were necessary.

The question, therefore, is this: Assuming that Merchandise knew or should have known of the kite did that fact constitute a defense to the action.

Although Bank of America is entitled to make this assumption, this case, like every law suit, involves more than a decision of technical law points. It also raises the basic question, is it right and just that Merchandise recover what it is seeking to recover. And so this Court in order to decide what is right and just will want to know the facts, that is, it will want to know which of these banks was responsible for the continuance of the kite. The fantastic story revealed by this record places that responsibility squarely on Merchandise.

If this Court, contrary to Bank of America's claim, concludes that the trial court's finding that Bank of America was in effect negligent is supported by the evidence, it will be called upon to decide whose fault was the primary cause of the continuance of the kite, that of Merchandise or of Bank of America. Although

on this appeal Bank of America, because of the trial court's failure to find with respect to the issue, is entitled to assume that Merchandise knew or should have known of the kite, still this Court, we feel sure, in deciding the point just mentioned will want to know the facts relating to Merchandise's behavior with respect to the kite.

2. The evidence shows without conflict that Merchandise knew or should have known of the kite.

When in this statement the expression, "checks on both sides of United's commercial account," is used it shall refer to checks drawn by Lofendo on his account with the Branch payable to the order of United which were credited to United's commercial account with Merchandise and to checks drawn by United on its commercial account with Merchandise payable to the order of Lofendo which were charged against United's commercial account.[11]

During the period from July 1st to November 19th Henry J. Reichwein was the cashier and vice-president of Merchandise and was the loan officer of plaintiff in charge of its business transactions with United, except that while Reichwein was away on his vacation from September 20th to October 18th LeRoy, to

[11]There was admitted in evidence as Defendant's Exhibit PP a photostat of United's commercial account with Merchandise for the period commencing July 1st to the date in November when the account was closed (II, 757). On this exhibit red lines were drawn through the figures representing the checks drawn by United to the order of Lofendo and debited against the account, and through the figures representing the checks of Lofendo payable to United credited to the account (II, 753-758).

whom we have already referred, was in charge of the account (III, 946, 956; II, 640-641).

William F. Collins testified that he at the time of testifying was the president of Lincoln National Bank of Chicago (III, 930); that towards the end of September, 1948, when he was cashier of Merchandise, he, after making a cursory examination of United's account, told LeRoy that in his opinion there was "a good possibility" that United was engaged in a kite (III, 936); that LeRoy then investigated the account and told Collins that he agreed that United might be engaged in a kite and that the matter should be discussed with Mr. Redheffer, who was president of Merchandise (III, 936); that Collins and LeRoy then had a discussion with Redheffer (III, 936); that in this discussion Collins told Redheffer that in his opinion the account indicated a possibility of check kiting and LeRoy suggested to Redheffer that a more thorough examination be made of the account and that Redheffer agreed that this should be done (III, 936-937).

LeRoy testified that he did not recall having a conversation with Collins in which Collins told him that there might be check kiting in the account, but that he would not deny that such a conversation took place (III, 628-629).

Redheffer testified that prior to November 17th he never had a discussion with an officer or employee of Merchandise in which he was told that United might be engaged in a kite (III, 1102).

Although Redheffer in effect contradicted Collins' testimony that Collins warned him that United might be engaged in a kite, LeRoy did not contradict Collins' testimony that Collins gave him such a warning. And so the testimony is uncontradicted that in the latter part of September Collins gave such a warning to LeRoy who was at that time the loaning officer in charge of the account.

LeRoy testified that although he did not recall discussing the account with Collins, he recalled discussing it with Redheffer (II, 631); that he discussed with Redheffer the fact that United was drawing heavily against uncollected funds and the fact that there were checks on both sides of the account (II, 632); and that they both agreed that an investigation of the account should be made with respect to these two matters (the drawing on uncollected funds and the checks on both sides) (II, 632); and that Tague, the outside auditor of the bank, was then instructed to examine the books of United with reference to these two matters (II, 632-633).

In November, 1948, and for approximately two years prior to that time Tague was an assistant credit manager of Merchandise and its chief field auditor (III, 1046). He made periodical audits of the United's books and made reports with respect to his audits, which were introduced in evidence as defendant's exhibit UU (III, 1050; and II, 780-783).

Pursuant to the instructions given him by LeRoy, Tague made a special investigation of United's books and made a report, dated October 1st (deft's. ex. R), based on this investigation (II, 633-634).

After the conclusion of the trial Bank of America prepared findings of fact which the trial court refused to sign. These findings appear on pages 119-164 of the record. We can curtail our statement of the evidence by referring at times to these proposed findings.

We will not discuss Tague's report of October 1st here. It is sufficient to say that for the reasons pointed out in Bank of America's proposed findings (I, 129-132) this report should not have allayed any doubts in the minds of Merchandise's officers with respect to the kite suggested by Collins, but should have accentuated their doubts. And LeRoy testified that when Tague submitted the report to him he asked Tague to explain it and that Tague replied by saying substantially what was in the report (II, 652); and that he could not understand the explanation (II, 652).

And the evidence shows without conflict that for the reasons pointed out in Bank of America's proposed findings (I, 130-131) Tague was grossly negligent in making not only his special investigation leading to the report of October 1st, but also his routine audits of United; that he did not notice discrepancies in United's books which would have been obvious to anyone on the most casual inspection and which would have disclosed at once the existence of the kite. Did Tague see these discrepancies and fail to report them, or was he hoodwinked?

On October 4th, after Tague had made his dubious report, LeRoy called in Rosenthal, the secretary of

United; and on October 4th he, Redheffer and Rosenthal discussed "the entire matter" (II, 654-655). In this conference Rosenthal gave LeRoy and Redheffer the same explanation of the checks on both sides as that given by Gassman to Tague as indicated in the latter's report (I, 655).

LeRoy testified:

"Q. And what did you reply to Mr. Rosenthal when he told you that [this explanation of checks on both sides], Mr. LeRoy?

A. If I remember correctly, I told him I didn't understand it.

Q. I will ask you if you didn't give this testimony at page 151 of your deposition:

'Q. Tell us the conversation between you and him at that time.

'A. In substance it was that he said that they paid out these funds for grapes, and then they sold and the proceeds were received by their agent, who was one of the three people referred to, and the agent remitted the money to them.

'I said, "Well, that is very nice, if that is the case, but have those funds deposited in the Bank of America Branch for the credit of the Merchandise National Bank of Chicago, for the United Produce Company and they will arrange for telegraphic advice to us, and the funds will be immediately available." '

Is that the testimony you gave?

A. Yes, sir.

Q. When you said to Mr. Rosenthal: 'Well, now, that is very nice, if that is the case,' did you believe the explanation he was giving you?

A. I didn't understand it" (II, 655-656).

LeRoy did not understand Tague's explanation of his report; and when Rosenthal gave him the same explanation, he did not understand it. Surely a report which one cannot understand is far from being satisfactory. And yet Merchandise was faced by a serious situation. Collins had warned it that United, to whom it was loaning its legal limit, might be engaged in a kite. It had ordered its auditor to investigate the checks on both sides. And its auditor, who had full access to United's books, had rendered a report which the officer then in charge of the loan could not understand. Did it then do anything more to investigate the transactions between United and Lofendo giving rise to the checks on both sides? The answer is that it did absolutely nothing.

In this conference with Rosenthal, LeRoy suggested to Rosenthal that United should cause the California funds to be deposited to the credit of Merchandise and should have the California bank give Merchandise telegraphic advice to that effect, but Redheffer told Rosenthal that Merchandise wanted "to go along and help him work out the situation" (II, 654-656).

United did not make the arrangement suggested by LeRoy, that is, it did not cause the California funds to be deposited to Merchandise's credit and Merchandise to be given telegraphic advice of that fact (II, 656).

On October 6th LeRoy told Rosenthal that he should arrange that United should not draw on un-

collected funds after October 13th (II, 659). United then asked LeRoy to permit it to continue to draw on uncollected funds until October 18th, and LeRoy with Redheffer's concurrence, told it that it could continue this practice until that day (II, 660-661). On October 18th, the day on which Reichwein returned from his vacation, LeRoy turned the supervision of the account back to Reichwein (II, 662). On October 18th United had not stopped drawing on uncollected funds and so Reichwein on that day and on later days requested Rosenthal to have United stop this practice.

It will be recalled that shortly prior to October 1st, LeRoy instructed Tague to make a special investigation of United with particular reference to its drawing on uncollected funds and to checks on both sides of the account. Reichwein testified that at no time prior to United's collapse on November 17th was he aware that there were checks on both sides of the United's commercial account and that no one ever called this fact to his attention (III, 1017-1021). The testimony is doubtless false. But whether true or false it shows a deplorable situation. If LeRoy when he turned the account back to Reichwein did not advise Reichwein of his suspicions, he was certainly most derelict. Reichwein should have known of the checks on both sides without being advised of the situation by LeRoy. And if he knew of it, whether because he was told by LeRoy or for some other reason, he should have been alerted to the dangers and should have done something to find out what

was going on. But Reichwein did nothing whatever with respect to the account except to give United the same directions which had been given United by LeRoy while Reichwein was on his vacation, that is directions to stop drawing on uncollected funds in its commercial account (III, 1004-1005). But United did not even stop doing this until the end of October (III, 1013); and then as will be stated later, it continued to draw on uncollected funds in enormous amounts by the use of its loan account.

And so the facts are that after Collins had given LeRoy his warning that United might be engaged in a kite and after Tague had made his dubious report, Merchandise did absolutely nothing to investigate the transactions between Lofendo and United giving rise to the checks on both sides; but that all Merchandise did was to direct United on several occasions to stop drawing upon uncollected funds; and that United despite these directions did not stop drawing on uncollected funds in its commercial account until the end of October. And during this time Merchandise was loaning United large sums; and was discounting for United drafts in a substantial amount; and during this time Merchandise had access to United's books and records and was in constant touch with its officers and employees. The only inference which can be drawn from these facts is that Merchandise, at least as early as the middle of October knew, or should have known, that United was engaged in a kite. But other evidence in the record places this fact beyond any doubt.

The records of Merchandise show the facts stated in this and the next two succeeding paragraphs.[12] During September Lofendo's accounts receivable aggregating $43,305.00 were assigned to Merchandise. During that month the total remittances received by Merchandise from United on account of accounts receivable aggregated $777,629.89. During that month the total Lofendo remittances represented by checks of Lofendo drawn on the Branch received by Merchandise aggregated $341,250.30, or about 44% of the aggregate.

During the month of October Lofendo accounts receivable aggregating $105,718.22 were assigned to Merchandise. During that month the total remittances received by Merchandise from United on account of accounts receivable aggregated $1,168,029.96; and during that month the total remittances represented by checks of Lofendo drawn on the Branch received by Merchandise aggregated $899,909.64, or 80% of the total.

During the first sixteen days of November Lofendo accounts receivable aggregating $434,527.69 were as-

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[12]It was stipulated that the schedule marked Defendant's Exhibit GG was a correct schedule of data from the interim and monthly assignments of accounts receivable of United to Merchandise during the months of September, October and November. 1948 (II, 776).

The remittance sheets, which were introduced as Defendant's Exhibits DD to FF, show the remittances received by Merchandise from United during September, October and the first sixteen days of November.

The schedule, Defendant's Exhibit GG, and the remittance sheets, Defendant's Exhibits DD to FF, show the data set out in above paragraph of the text.

signed to Merchandise. During these sixteen days the total remittances received by Merchandise from United on account of accounts receivable aggregated $1,087,046.62. During these sixteen days the total remittances represented by checks of Lofendo drawn on the Branch received by Merchandise aggregated $998,326.98, or about 90% of the total remittances.

The fact, therefore, is that Lofendo checks, which were being used as part of the kite, were pouring into Merchandise in constantly increasing and fantastic numbers and amounts.

As already stated, the practice pursued by Merchandise was that on the same day it received a remittance from United it would loan United an amount equalling the remittance and would take a new note to evidence the loan and would credit the proceeds of such loan to United's commercial account. (See the discussions on pages 23 to 26 of this brief.) Merchandise's loans to United, which were related in this way to the Lofendo checks, increased from $341,250.30 in September to $899,900.69 in October and to $998,-326.98 during the first sixteen days of November. What sort of banking was this?

Although the Lofendo checks did not create credits in United's commercial account, still under the practice just referred to the delivery of such checks lead to a new loan and the new loan to such credits.

And so United carried on the kite, not only by depositing Lofendo checks to its credit in its commercial account, but also by delivering Lofendo checks

to Merchandise as remittances on account of accounts receivable and at the same time getting new loans which were then credited to its account.

And likewise United was drawing on uncollected funds, not only by depositing Lofendo checks to its credit in its commercial account and drawing on such checks before they were collected, but also by delivering Lofendo checks to Merchandise as remittances on account of accounts receivable and at the same time getting new credits for the loans then made it before the collection of the remittance checks. The uncollected funds on which Lofendo was drawing by the latter method were constantly increasing until on November 15th they had reached the enormous total of $602,535.61 (II, 776-777).

Another circumstance should be mentioned. Owing to the practice of preposting of in-clearings and delayed posting of counter work, the daily balance appearing in United's commercial account on any given day was not a true balance, but was what was called "a noonday balance" (III, 961). In order to arrive at the true balance for any particular day, it was necessary to add to the noonday balance of that day the sum of all in-clearings posted under that date (III, 962).

During the month of July, there was a noonday overdraft in the commercial ledger of United with Merchandise on eight days; in August on ten days; in September on five days; in October on ten days; and from November 1st to November 16th on five days (deft's. ex. QQ; II, 768); and on each of these

days on which a noonday red balance was posted to United's account (which posting was done on the day succeeding the day as of which the entry was made) it was necessary for United to create credits to its account so that on the day of posting the noonday overdraft would not on that day become an actual overdraft.

Reichwein saw Gassman, the bookkeeper of United, almost every day (III, 977). Gassman would bring in to Reichwein for his approval notes to evidence new loans and drafts of United which he was presenting to Merchandise for discount (III, 978-979).

Whenever there was a noonday overdraft in United's commercial account the fact that there was such an overdraft and the checks creating it would on the day of posting be called to Reichwein's attention for his approval (III, 971-975). And Reichwein would not approve the noonday overdraft unless on that day a new credit had been given United (III, 985-986). These credits arose out of loans made by Merchandise to United or the discount by Merchandise of drafts of United (III, 986-989).

We must infer from these circumstances that whenever a noonday overdraft was posted on the ledger sheet, United would be notified of this fact and that United would then supply the necessary credits to meet the overdraft by securing Reichwein's approval of new notes or drafts.

Now Merchandise cannot excuse itself for the deplorable and fantastic situation which we have just

been describing, by simply saying that it did not know about it. The facts appeared in its record and it was charged with knowledge of what was shown by its records. In a discussion between court and counsel during the trial respecting certain facts shown by Merchandise's records, the court said:

> "The Court. They knew about the account. If the bank's records show it, it is knowledge to the bank" (II, 786).

Of course, this is so.

Reichwein testified that when LeRoy told him that LeRoy had told Rosenthal to stop drawing against uncollected funds, LeRoy did not call to his attention "any uncollected activity" except that arising from deposit of checks to the commercial account (III, 1010-1011). He then testified:

> "Q. Did you thereafter inquire whether or not there was any uncollected activity, as we have expressed it, in connection with payments being made by the United Produce Company on account of its obligation to the bank?
>
> A. On accounts receivable?
>
> Q. Yes.
>
> A. No, sir" (III, 1011).

But Messenger testified that loaning officers should keep in constant touch with all the records of the bank relating to loans made under their supervision (I, 277-278); that among other things they should observe whether or not a customer is discounting drafts drawn on the same drawee in very large sums of money (I, 278); that, in other words, they should

determine whether or not there is any concentration in the drafts of one drawee (I, 278-280); and then he went on to testify:

> "Q. And they should determine whether there is any concentration in the assignment of accounts receivable of any one debtor?
>
> A. They should.
>
> Q. And whether or not there is any concentration in the receipt of payments from any one debtor?
>
> A. They should" (II, 280).

This, of course, goes without saying; but if there were any need for proof of the fact, we have it here in this testimony of Messenger.

Reichwein wanted us to believe that he, like the proverbial ostrich, had simply stuck his head in the sand and knew nothing about the account. But he was the officer of Merchandise in charge of its loan to United; and so he knew, or should have known, of the Lofendo checks on both sides, Collins' warning, and the unsatisfactory Tague report; and he knew, or should have known, of the tremendous concentration of Lofendo checks received as remittances in September; that this large concentration more than doubled in October; and that it increased again in the first half of November. And he should have known that after he asked United not to draw on uncollected funds, it, by making use of the practice we have described, had continued in effect to draw in huge amounts on uncollected funds.

Reichwein was approving the new loans to United (III, 977-979). And so he knew, or he should have known, that Merchandise made new loans to United which were related in the manner we have described to the Lofendo checks, in the following amounts: $341,250.30 in September; $899,900.64 in October, and $998,326.98 during the first seventeen days of November.

The things that went on in Merchandise's office respecting the United account were so flagrantly bad that they could not have been overlooked. It must be inferred, therefore, that Merchandise had knowledge of them. But if it did not actually know about them, it should have known of them. Under circumstances of this sort means of knowledge are the equivalent of knowledge. California Civil Code, sec. 19; 20 Cal. Jur. 234-237, sec. 4.

On November 13th Bank of America wired Merchandise that it was rejecting Lofendo checks aggregating $57,694.97 because of insufficient funds, and Merchandise received this wire on November 15th, which was a Monday (I, 379-381). These were the first Lofendo checks rejected by the Branch. When Merchandise received this wire, it did nothing with respect to the United account. On November 16th Bank of America wired Merchandise that it was rejecting additional Lofendo checks aggregating $110,-265.04 for the same reason (I, 381-382; II, 718-719). When Merchandise received this wire on November 17th, it called in Rosenthal, the secretary of United,

who then told Merchandise that he had been carrying on transactions which might cause Merchandise a severe loss (II, 718-719). United thereupon collapsed and the kite ended.

When United collapsed Lofendo checks for $534,-548.18, which had been taken by Merchandise as remittances and which were part of the kite, were outstanding. These checks were never collected. Merchandise took a loss arising out of the kite in the amount of these checks. If the judgment of the trial court stands, Merchandise will have recovered from defendant $203,047.60 of its loss with interest.

In the light of this record, it is not just that Merchandise should reduce the loss which it brought upon itself by mulcting Bank of America in this amount.

And as we will show later, under the law the fact that it knew, or should have known of the kite, precludes it from recovering.

3. Bank of America was not negligent in not having discovered the kite; and Merchandise falsely represented to Bank of America United's condition in order to induce Bank of America to continue to pay Lofendo checks.

Although the trial court made no findings with respect to the issue whether Merchandise knew, or should have known, of the kite, it did find that as early as October 22nd, defendant became suspicious that the Lofendo account was being operated as part of a kite, and that on November 10th, Bank of America became positive that the transactions between Lo-

fendo and United "were not ethical but were part of some dishonest scheme" (I, 105).

The court also found that it is not true that Merchandise ever made any representation to the Bank of America to induce it to pay checks drawn on the Lofendo account to the order of United or to induce Bank of America to give Lofendo credit for checks drawn by United to his order; and that it is not true that Bank of America, in reliance on any representation of Merchandise, ever paid any checks drawn on the Lofendo account or ever gave Lofendo credit for checks of United (I, 113).

Both these findings are erroneous. The record shows without dispute that the Branch was not negligent in not discovering the kite, and that Merchandise by Reichwein's wire of October 20th did make representations to Bank of America to induce it to continue to pay checks of Lofendo drawn on the account and to credit Lofendo with checks drawn to his order by United; that these representations were fraudulent; and that they were relied on by Bank of America.

(a) What took place in the Branch prior to its receipt of Reichwein's wire of October 20th.

Estribou testified that he had been manager of the East Bakersfield Branch of Bank of America for over fifteen years (I, 392-393; I, 205-206); and that his Branch had deposits of about $20,000,000.00 in 1948. In other words, the Branch was not a small banking operation.

He also testified that Tozzi, a farmer and shipper with a good reputation in the community, introduced Lofendo to Estribou on March 12, 1948, when the Lofendo account was opened (I, 392); that he met Lofendo only once and that was when the account was opened (I, 206); that after Lofendo opened the account Estribou never saw him in the Branch, but just saw him in passing occasionally at lunch (I, 373); that Lofendo was a stranger to him and to the other officers of the Branch (I, 206); that the original deposit which Lofendo made was in cash, but that all of his other deposits came in the mail (I, 207); and that after Lofendo opened the account Estribou had no real contact with him (I, 393); and that Lofendo never borrowed money from the Branch and never applied to the Branch for a loan (I, 393).

Cosgrove testified that he has been the assistant manager of the East Bakersfield Branch since June, 1948 (II, 433); that Tarr was the operations officer of the Branch (II, 433); that while Tarr was on his vacation during the period from October 11th to October 18th, Cosgrove had occasion to observe the Lofendo account (II, 433-434); that pursuant to the practice of the Bank the bookkeeper called to his attention the fact that a large number of checks in large amounts were being deposited and being checked out (II, 434); that he then took a look at the account and found that checks payable to United were being drawn on the account and checks drawn by United were being deposited to the credit of the account (II, 434), and that the Bank was paying checks

drawn on the account before checks deposited had a chance to clear (II, 435); that he thought these circumstances required explanation (II, 434-435); that when Tarr returned from his vacation Cosgrove told him what he had discovered about the account (II, 434); that Tarr said that he would wire Merchandise regarding United (II, 440); that the response Tarr got from his inquiry was Reichwein's wire to Tarr of October 20th (Deft's Ex. 0); and that he saw this wire either on the day it was received or the day following (II, 440; II, 440-441).

Estribou testified that the Lofendo account was brought to his attention by Tarr; that he then learned that checks of the United were being deposited to the credit of the account and checks payable to the United were being drawn on the account (I, 361-362); that because of the size of the checks and the activity in the account he considered this a most unusual situation (I, 362); that he then instructed Tarr to make inquiry of Merchandise respecting the standing of the United (I, 385-386); that when the wire of October 20th from Merchandise was received, it was shown him (I, 386); that Tarr later told him that he had contacted the Fresno Branch as suggested by the wire; and that Tarr did not tell him in detail what he had learned from the Fresno Branch, but that Tarr did tell him that it was along the same lines as the wire, that United had a good record (I, 387).

(b) Reichwein's wire of October 20th; the wire made representations to Bank of America which were fraudulent.

Reichwein's wire to Tarr of October 20th said in part:

> "* * * we loan them legal limit on secured basis. Net worth of company over eighty thousand dollars. Impossible for us to set limit on acceptance of their checks. Up to present have never returned any checks. Suggest you contact your main branch at Fresno, California, who have complete information."

Tarr thereupon telephoned the Fresno Branch and asked Nelson, the man there with whom he talked, for information on the credit responsibility of United (II, 574-575). Nelson then read to Tarr over the telephone a letter, dated September 22nd, defendant's exhibit Q, which Merchandise had written the Fresno Branch (II, 577-578). Reichwein testified that when his wire of October 20th suggested that Tarr ask the Fresno Branch for information, he referred to this letter (III, 992-993).

This letter stated that United was well and favorably known to Merchandise; that United had a very satisfactory account with it in which United maintained balances averaging five figures; that Merchandise was loaning United up to its legal limit of $200,000.00 under special arrangements and had found that United made proper use of the commitment; and that United was making progress from the standpoint of operations (IV, 1272-1273).

Much of the information given by the wire and obtained from the Fresno Branch pursuant to the suggestion made by the wire was completely false. The letter says that United was maintaining "balances averaging in satisfactory five-figure proportions"; but as we have already pointed out there were frequent noon day overdrafts which would have been actual overdrafts on the days on which such overdrafts appeared if not met by additional loans or discounts. The letter says that United was making "proper use" of the loan being made to it; but it was not; at the very time when the wire of October 20th was sent Lofendo checks in tremendous amounts were pouring into Merchandise as remittances on account of accounts receivable which certainly did not indicate a proper use of the commitment. The letter says that "the company is making progress from the standpoint of operations". But a company which has frequent noon day overdrafts and is drawing heavily on uncollected funds and is making remittances on account of pledged accounts receivable of one debtor in extremely large amounts, is not making progress from the standpoint of operation. And the letter says that Merchandise has "come to entertain a favorable regard for the account"; but in view of what had occurred respecting the account from the time Collins started his investigation to the date of Reichwein's wire Merchandise could not possibly have entertained such a regard for it.

We cannot conceive how Reichwein could have been unaware that the information he was giving Bank of

America was false. But even if he believed what he told Bank of America, he would still be guilty of making false representations. The law is that where a party makes a representation without reasonable ground for believing it to be true, he is just as guilty of fraud as though he knew his representation was false. Sec. 1572 of the California Civil Code.

What could have prompted Reichwein to send the wire of October 20th? It is impossible to believe that he and the other officers of Merchandise were being completely hoodwinked. The evidence of the fraud was right under their noses; one can say that their noses were being rubbed in it.

(c) What took place in the Branch after receipt of Reichwein's wire of October 20th. Bank of America relied on this wire.

After Tarr had received the wire, Estribou did not terminate the Lofendo account, but he gave instructions that the Branch should not accept for immediate credit checks of United being drawn to the order of Lofendo until Lofendo could be contacted and his methods of operation discussed (Tarr's memo of October 22nd, pltf's. ex. 12; IV, 1174B, and II, 562, 579-580). At that time Tarr placed a "hold" on the Lofendo account, that is he arranged that the Branch upon receiving checks for deposit in the Lofendo account should give Lofendo credit for them, but should not pay checks against such credits until the checks credited to the account had an opportunity to clear (II, 563; 581).

After Estribou had given these instructions, Tarr made an effort to contact Lofendo and as a result of this effort towards the latter part of October, Lofendo and Rosenthal appeared at the Branch and conferred with Cosgrove (II, 572-573; 580). Cosgrove told Lofendo and Rosenthal that his Branch wanted Lofendo to give checks deposited to his account a chance to clear before he drew checks against them; that the Branch wanted Lofendo to maintain a larger balance in the account; and that it wanted an explanation of the checks payable from Lofendo to United and from United to Lofendo (II, 436-437). Rosenthal thereupon explained these checks to Cosgrove by telling him in effect that when United made a purchase for Lofendo's account, Lofendo would give it a check for the amount and that United would then sell the produce and give Lofendo a check for the proceeds (II, 437). Cosgrove then told Rosenthal that he wanted a letter from United giving this explanation so that the Branch would have a record in its files that the transactions between Lofendo and United giving rise to the checks on both sides were bona fide purchases and sales (II, 438). Rosenthal replied that he would give the Branch such a letter (II, 438-439). Cosgrove then told Estribou and Tarr what had been stated in the conversation and that he was satisfied (II, 438; I, 388-389). The account was then carried on substantially as it had been previously (I, 388-389).

Merchandise argues that the fact that Estribou gave his instructions to Tarr of October 22nd and the fact that Tarr brought Lofendo and Rosenthal

into the Branch to hear their explanation shows that Bank of America did not rely upon Reichwein's wire of October 20th and the information obtained from the Fresno Branch. The contention is clearly untenable. When Tarr on October 20th called the account to Estribou's attention, Estribou was called upon to take some action. The account struck him as an unusual operation. He could either have terminated it or let it continue. There was no reason for him not to terminate it. Lofendo was just a depositor of the Branch and a stranger to its officers. The Branch had not made him any loans. There can be no doubt that Estribou in not terminating the account, but in permitting it to continue relied on the excellent character given United by Reichwein's wire of October 20th and the letter of September 22nd; but at the same time he as a prudent banker wanted to know more about the account.

To test whether Estribou relied on Reichwein's wire, let us assume that the wire had stated just part of the truth, a relatively small part. Let us assume, for example, that the wire had stated that there were frequent noon day overdrafts in the United account which could only be met by plaintiff making United additional loans; that at the end of September an officer of Merchandise had made a cursory examination of the account and had noticed the checks on both sides and that United was drawing heavily on uncollected funds; and that Merchandise then, after its auditor had made an investigation, had requested

United to stop drawing on uncollected funds, but that United still persisted in doing so. This would only have been a small part of the truth; but there can be no doubt that if Reichwein had sent such a wire to the Branch, Estribou would have terminated the account immediately. This demonstrates, if demonstration be required, that the Branch by continuing the account relied upon the wire.

37 C. J. S. 287 states:

> "It is not essential to redress [for fraud] that a representation or concealment should have been the sole cause of action, but it is sufficient if it constituted one of several inducements and exerted a material influence."

After the lapse of about ten days following Cosgrove's discussion with Rosenthal and Lofendo, Cosgrove and Tarr again discussed the account before the officers' meeting of the Branch on November 10th (II, 438). Tarr told Cosgrove that the account had not improved and Cosgrove informed Tarr that the letter for which he had asked Rosenthal had not been received and that he believed that the account should be discussed at the officers' meeting (II, 438-439). The account was then discussed at a meeting of the officers of the Branch on November 10th; and at this meeting Estribou gave instructions that when Lofendo deposited checks he should not be given credit for them, but that the checks should be sent on for collection (I, 366; 389-390; and Tarr's memo of November 15th, plt's. ex. 13; IV, 1174C).

As already stated, on November 12th the Branch rejected its first group of Lofendo checks for $57,-694.97 because of insufficient funds, and on November 16th, it rejected another group of Lofendo checks for $110,265.04 for the same reason.

The finding of the trial court, that on November 10th Bank of America became positive that the transactions going on between Lofendo and United were not ethical, was based on Estribou's testimony. But Estribou's testimony is that it was not until after the Branch rejected the second group of checks that he became positive that something wrong was going on in the account. On direct examination by Merchandise's counsel, he stated:

> "Q. On November 10th, ten days afterwards, when you made this new insistence that items be taken for collection only, it is a fact, is it not, that you then became positive, if you had not been theretofore so, that the operations between United and Lofendo were not ethical?
>
> A. I was not positive, no. That is what we were trying to determine by having them come in there.
>
> Q. If you were not positive, you felt very strongly about it, that it was not ethical?
>
> A. I still wanted to be safe rather than sorry" (I, 369).

His attention was then called to Bank of America's wire to Merchandise of November 13th notifying Merchandise of the rejection of the first group of checks. And he was then asked:

"Q. Is it a fact that on this day, November 13th, you were almost positive that something was going on that was not ethical between Lofendo and United Produce Company?

A. Yes, we suspicioned that, yes.

Q. This is your testimony, is it not?

A. That is correct, yes.

Q. Did anything happen between November 10th, when you gave positive instructions that Lofendo items were to be taken for collection only, and November 13th, to increase your suspicion, or was your frame of mind the same on November 10th as it was three days later?

A. It is pretty hard to answer that question, between the 10th and the 13th. That is a long time ago (I, 372-373).

Q. Yes, and your state of mind about the unethical quality of the transactions between Lofendo and United Produce was just the same on the 10th as it was three days later, was it not?

A. I think so" (I, 373).

Then on cross-examination by Bank of America's counsel his attention was called to certain testimony given by him in his deposition to the effect that he first suspected a check kiting operation after he received telephone calls from various parts of the United States indicating that United had a large amount in checks "floating around with no funds to meet them" (I, 382). He then testified that these telephone calls were received in the week commencing on November 15th (I, 383); and he then testified:

"Q. Now can you say, Mr. Estribou, with reference to these telegrams and these phone calls and the testimony that I have read to you, can you give us approximately the date when you first suspected that a kiting operation was going on? That is, felt ethically—felt that something ethically wrong was going on? When did you first suspect that, when did you first feel that?

A. Well, right after we returned these checks.

Q. Which checks?

A. His checks—Lofendo's checks.

Q. Well, with reference to these wires, can you give approximately the date when you had that feeling that something ethically wrong was going on?

A. Oh, I would say it was around the 13th, 14th, in there" (I, 383-384).

Estribou also testified:

"Q. In other words, Mr. Estribou, you do not charge a man with fraud, kiting, or anything else unless you have some proof that that is what he is doing, is that right?

A. That is correct.

Q. On November 10th you did not have any proof of that sort with respect to this account?

A. None whatsoever" (I, 391).

And it is a fact that on November 10th Estribou had no such proof. On that date, the only thing that had occurred adverse to Lofendo which had come to the notice of the Branch was that Lofendo had not supplied the Branch with the letter which Cosgrove had requested. But this circumstance was not of such a serious import as to lead the Branch to believe that

Lofendo and United were engaged in a fraudulent kiting operation, particularly in view of Reichwein's wire to Tarr of October 20th, and the information which pursuant to Reichwein's suggestion Tarr had obtained from the Fresno Branch. It was not until checks began "to bounce," not only at the Branch, but elsewhere, that Estribou and the others at the Branch could conclude that there was something wrong going on.

It was Cosgrove, not Estribou, who had handled the matter. And Cosgrove testified:

> "Q. When you left on your vacation, on November 13th, did you suspect or believe that the United Produce Company and Lofendo were engaged in a kiting operation?
>
> A. No, sir" (II, 443).

We submit that the trial court's findings that Bank of America became suspicious of a kite on October 22nd and positive of it on November 10th is not supported by but is contrary to the evidence and is therefore erroneous, and that the same thing is true of the trial court's findings that Merchandise made no representation to Bank of America to induce it to pay checks drawn by Lofendo on his account.

4. Regardless of whether or not Bank of America was negligent in not having discovered the kite, the fact that Merchandise knew of the kite, prevents its recovery. And so the issue whether Merchandise had such knowledge, was material.

(a) The law is that "A mistake which authorizes recovery exists only when the payor is unconscious of any error or ignorance * * *" 70 C. J. S. 369, sec. 157(b). See also the Restatement, Restitution, sec. 6.

This must be so because if the payor knows the facts, then he is not laboring under a mistake and so has no ground on which to recover.

In substance Merchandise maintains that the mistake it made which justifies its recovery consisted in its erroneous belief that its transactions with United giving rise to the credits to United's account against which the checks were charged were bona fide transactions, whereas in fact they were part of the kite.

As the trial court made no findings with respect to the issue whether Merchandise knew of the kite, it must, as we have stated, be assumed on this appeal that it had such knowledge. And the record we have reviewed shows that it did in fact have such knowledge.

It follows that as it was not laboring under the mistake on which it must base its claim, it cannot recover. And this, of course, is true whether or not Bank of America was negligent in not discovering the kite.

(b) The textwriter in 40 Am. Jur. 848, sec. 194, says:

> "* * * and it has been held that an action for the recovery of money will not lie where money has been paid by a mistake which arose from the fault or negligence of the party paying, and cannot be recovered without prejudice to the party who has received it."

The same principle is stated in effect in the Restatement of Restitution, sec. 142, pages 567, 568-569, and 573-574. We quote the following short extract:

> "Any change of circumstances which would cause or which would be likely thereafter to cause the recipient entire or partial loss if the claimant were to obtain full restitution, is such a change as prevents full restitution if the recipient was not guilty of a tort nor substantially more at fault than the claimant. * * *"

The rule, therefore, is that if the mistake inducing the payment was due to the negligence of the payor and if its recovery will cause the payee prejudice, the payor cannot recover.

The mistake of Merchandise which induced its payments of the checks was its belief that the Lofendo checks delivered to its as remittances in connection with which it made loans to United were bona fide, whereas in fact they were part of the kite. Assuming that Merchandise did not actually know that the kite was going on, its mistake was certainly due to its gross negligence.

In *Citizens State Bank v. Western Union Telegraph Co.,* 5 Cir., 172 F. (2d) 950, the court held that the bank could not recover from the telegraph company an overdraft in the latter's account, because the overdraft was due to a kite which the bank negligently allowed an employee of the telegraph company to carry on. The court said, at page 952:

> "* * * But for the inexcusable conduct of the bank in permitting, if not encouraging, and in part inducing, the system of continuous kiting of checks which went on for so long, no substantial loss could have occurred. Had the bank acted in good faith, had it exercised the slightest dili-

> gence, it would have put a stop at once to the remarkable goings on between McGuire and Frase, and at once notified plaintiff of them. Had it done so, the wrong doing would have been stopped in its beginning, and no loss would have occurred."

Paraphrasing this statement we can say that if Merchandise had acted in good faith, if it had exercised the slightest diligence, "it would have put a stop at once to the remarkable goings on" between United and Lofendo, and it would not have made the mistake it did make in paying the checks.

If Merchandise is permitted to recover, Bank of America, as a result of the kite, will have taken a loss of $174,192.34. This, of course, will constitute serious prejudice.

As we have seen, Bank of America's position was changed by the Merchandise's payments of the checks. But if we assume for argument's sake that it was not, still Merchandise's mistake in paying the checks was due at the very least to its gross negligence; and if it is allowed to recover Bank of America will suffer serious prejudice; and so under the rule of the authorities we have cited Merchandise cannot recover.

And this is so whether or not Bank of America was negligent in not discovering the kite.

In *Bank of America v. Universal Finance Co.,* 131 Cal. App. 116, 126, 21 P. (2d) 147, 151, the court said:

> "* * * where one of two innocent parties must suffer, the burden should be borne by the one whose action was the primary cause of the loss."

And in *United States v. First National Bank,* 10 Cir., 124 F. (2d) 484, 488, the court said:

> "* * * as between two innocent persons, both of whom are victims of fraud, the burden must fall upon the one whose negligence first facilitated and made possible the loss."

See also: Restatement, Restitution, section 142, quoted from above, and 18 Am. Jur. 335-336.

Merchandise was lending United large sums and discounting United's drafts in large amounts; it was in constant touch with United's employees and officers; it was making periodical examinations of United's books and was familiar with its affairs; and yet it permitted United to engage in the practices which we have described and which the slightest investigation would have disclosed. Whereas Lofendo used the Branch merely as a depositary; he never applied to the Branch for a loan and was practically a stranger to its officers; and when the Branch inquired of Merchandise as the bank financing United respecting its character and financial responsibility, Merchandise replied by fraudulently misrepresenting these things to the Branch. If it be assumed that Merchandise did not know of the kite but was only guilty of negligence in not having discovered it, there can be no doubt that its acts were the primary cause of the loss.

5. A summing up of the discussion under this heading H to this point.

The evidence shows without conflict that Merchandise knew, or should have known, of the kite; and

in view of the trial court's failure to find respecting the issue, it would have to be assumed for the purpose of this appeal that Merchandise had such knowledge if such knowledge would be a defense to this action.

There can be no doubt that it is a defense and that therefore the failure of the trial court to find respecting the issue is reversible error.

It is a defense for these reasons: First, as Merchandise knew that the kite was going on, it was not laboring under the mistake upon which it bases its right to recover. Second, as Merchandise at the very least was guilty of the grossest negligence in making the payments, and as Merchandise's recovery of them will cause Bank of America serious prejudice (a loss due to the kite in the sum of $174,192.34, with interest), Merchandise cannot recover.

6. As Merchandise knew or should have known of the kite, it will be liable to Bank of America under defendant's counterclaim in the event it is held that Merchandise is entitled to recover in this action. And so the issue whether Merchandise had such knowledge was material.

All those participating in a fraud are liable for the damages suffered by the injured party. *Swasey v. de L'Etanche,* 17 Cal. App. (2d) 713, 718, 62 P. (2d) 753, 755; *State v. Day,* 76 Cal. App. (2d) 536, 550, 173 P. (2d) 399, 407-408.

There can be no doubt that if Merchandise knew of the kite and permitted it to go on, it was in effect participating in the fraud being perpetrated by United and Lofendo on Bank of America.

Bank of America's counterclaim, therefore, was sound; and so the issue of Merchandise's knowledge of the kite was material; and the trial court's failure to find respecting it was reversible error.

I. THE TRIAL COURT'S FINDINGS THAT BANK OF AMERICA ENTERED INTO A CONTRACT THAT IT WOULD NOT ACT UPON THE ADVICE OF CREDIT WITH RESPECT TO THE SIX CHECKS WHEN RECEIVED IS NOT SUPPORTED BY THE EVIDENCE; BUT SUCH AGREEMENT, IF MADE, WAS VOID AND UNENFORCEABLE.

1. These findings are not supported by the evidence.

The findings are that on November 17th Merchandise telephoned Bank of America and informed it that the advice of credit respecting the six checks had been sent out by mistake and as a result of a fraud perpetrated by United; that Merchandise, upon being informed by Bank of America that this advice had not yet been received, "informed defendant that the advice of credit had been rescinded and revoked"; that in the conversation "defendant agreed with plaintiff not to act upon the advice of credit if and when it should be received and agreed to return it to an emissary of plaintiff"; that on the next day, November 18th, Merchandise advised Bank of America that the "advice of credit had been sent out by mistake, that it was rescinded and revoked * * *"; and "that on the same day defendant agreed that it would not act upon the advice of credit when received" but would return it (I, 101-103).

The findings with respect to the telephone conversation of November 17th are based on the conversation of Messenger and Estribou of that day; and the findings with respect to what occurred on November 18th are based on the conversations between LeRoy and Duncan and Johnson of that day.

Messenger testified that after Rosenthal had come into Merchandise's office on November 17th and had talked to Redheffer and Reichwein, he was later told what Rosenthal had said in this conversation; and that he then looked into the United's account and telephoned Estribou (I, 215-217). He then testified that in his telephone conversation with Estribou he told Estribou that United had perpetrated a fraud on Merchandise, and that one of its officers had admitted that it had pledged fraudulent accounts as collateral to Merchandise (I, 220-221); that he had a list of checks received from Lofendo and wanted to ascertain whether or not any of these checks had been paid (I, 221); and that Estribou then called off the checks which Estribou's record showed had been paid and that he checked off the items on his list (I, 222-223).

Now we can come to the crux of his testimony which was as follows:

> "A. * * * I told him [Estribou] that on November 15th we had mailed an advice of credit covering a collection of six checks of Frank C. Lofendo forwarded to us by their branch, totalling $113,216.50, and that the advice of credit had been sent out in error. I asked him whether or

not the advice had been received by him. He told me that the advice had not been received by him. I told him that it was our desire that their bank not make any entry on that advice of credit as we were rescinding the credit, and Mr. Estribou told me that he would be happy to work with Merchandise National Bank; that in so far as the Lofendo account was concerned, they had not been paying against uncollected funds, they were in the clear; they had a balance of $699.02. He stated that they would work with us; they would do anything we wanted them to do; they would pay checks that we would present to them for payment or they would not make entry whichever we desired. * * * I informed Mr. Estribou that that it was not our desire that they pay checks, but we were rescinding the advice of credit; the Merchandise National Bank didn't want them to make entry on the credit. Mr. Estribou said 'I agree with you; then we won't make entry.' * * * I told Mr. Estribou that Mr. LeRoy, one of our vice-presidents, was flying out to California that night and that he would be in Bakersfield the following day and that it was our desire that he deliver to Mr. LeRoy the advice of credit that we had rescinded" (I, 223-225).

Estribou testified that in the telephone conversation he told Messenger that he could not comply with Messenger's request not to enter the credit; that he had no right not to enter it; but that he assumed Messenger was in trouble and he would be happy to do anything he could to assist Messenger and his bank, provided it did not cost his bank anything;

and that if Messenger had checks from Lofendo and sent them out to the Branch and the Branch had a balance, he would give Merchandise preference (I, 396-398).

The resolving by the trial court of this conflict against Bank of America is, of course, binding on Bank of America in this appeal.

In 17 *C.J.S.* 387-388, the textwriter says:

> "Offer and acceptance, to be effective in creating a contract, must manifest an intention to affect legal relations between the parties."

Broad Street National Bank of Trenton v. Collier, 112 N.J.L. 41, 169 Atl. 552, was a suit on a promissory note brought by plaintiff bank against defendant accommodation endorser. Plaintiff bank had had in its hands $10,000.00 belonging to the maker of the note. Defendant, knowing this, had written plaintiff bank requesting it to "take care of me," that is apply the $10,000.00 on the note. Plaintiff bank replied "shall be very glad to comply with your wishes." The court held that the correspondence did not create a contract binding plaintiff bank to apply the $10,000.00 on the note. It said at pages 553-554:

> "An offer, to constitute a contract, must be one which is intended of itself to create legal relations on acceptance. 6 R.C.L. p. 600. The agreement must purport to produce a legally binding result, or, to put it in another form, the intention of the parties must refer to legal relations. It must contemplate the assumption of legal rights and duties. 13 C.J. 286. An offer is a

statement by the offeror of what he will give in return for some promise or act of the offeree. As the offeror's statement necessarily looks to the future, it must always be promissory in terms. I Williston on Contracts, 30. An expression of desire or hope is not of itself an offer which will become a contract upon acceptance by the adversary party. * * *

A declaration of intention to act in a certain way, which does not show that the party who makes such declaration promises to act in such way, or intends to incur a legal liability obliging him to act in such way, is not an offer which can be accepted so as to make a contract. If it is sought to make an offer which, on acceptance, can become a contract, the words or acts by which it is made must show intention to assume liability. 1 Supp. Page on Contracts, secs. 77, 79.

The offer and acceptance must have the characteristics of a binding bargain. Such was not the case here. Appellant, in the letter referred to, merely expressed the hope that his note would 'be taken care of.' He was seeking the aid and assistance of Mr. Wicoff, and the latter expressed a willingness to help, but it is evident that it was not in the mind of either party that their legal relations were to be affected by a binding contract."

Accepting Messenger's version of the conversation as correct, the question is does it show an intention on the part of Messenger and Estribou to alter the legal rights and duties of the banks; or to put the

point in another way did Messenger make an offer and did Estribou accept it, all for the purpose of creating a binding contract between the banks? "An offer is a statement by the offeror of what he will give in return for some promise or act of the offeree." Did Messenger state that Merchandise would give something in return for some promise or act of Bank of America?

Just before Messenger telephoned Estribou he had been told that Merchandise was to take a loss because of United's fraud. He telephoned Estribou to find out how many of the Lofendo checks had been paid; and he then told Estribou, according to his testimony, that Merchandise had sent out the advice of credit in error; that it did not want the Branch "to make any entry on that advice of credit as we were rescinding the credit"; that "it was not our desire that they pay checks, but we were rescinding the advice of credit"; and that Estribou replied, "I agree with you; then we won't make entry."

Messenger did not telephone Estribou to negotiate a contract. Messenger telephoned Estribou to give him instructions; to tell him that Merchandise was revoking the advice of credit because it was paid in error and that Estribou should not credit it to the account or pay checks against it; and, according to his testimony, Estribou said that he would follow the instructions. Messenger made no offer to give something in return for some act or promise of Bank

of America. He made no offer at all; and Estribou accepted none. The conversations had none of the characteristics of a binding bargain. There was no intention to create a contract and none was created.

Nor did the conversations of November 18th between Leroy on the one hand and Duncan and Johnson on the other give rise to a contract.

For the purposes of this appeal we must accept LeRoy's versions of these conversations.

LeRoy testified that when he saw Duncan in the office of Bank of America in the morning of November 18th he told Duncan that Merchandise had been swindled and had suffered a heavy loss in the United transactions (II, 480-481); that he had with him a list of the Lofendo checks, the fate of which he wanted to learn (II, 483); that after Duncan had telephoned Estribou in his presence, Duncan told him that the Branch had a credit balance of approximately $690 (II, 452-455). Then LeRoy testified:

> "Q. Was anything said in either of the telephone conversations [Duncan's telephone conversation with Estribou] about the advice of credit?
>
> A. Yes. Mr. Duncan in both of them told them that it had been revoked and that the head office was familiar with the fact. In the first one he did not say they concurred with it, but in the second he said—I wouldn't say definitely that he said he concurred with it but he said it had been revoked.
>
> Q. Was anything said about what was to be done with it, the physical disposition?

A. It was to be returned to me.
Q. To you when?
A. When I went to Bakersfield the next day" (II, 456-457).

LeRoy also testified that Duncan wanted to consult with Johnson, as one of the attorneys for Bank of America, to learn whether Bank of America could return the Lofendo checks in which LeRoy was interested without their actual presentation to the Branch on which they were drawn (II, 485-486); that he and Duncan then went to Johnson's office (II, 486); that Johnson stated that his opinion was that Bank of America could return the checks without their presentation, provided Bank of America was authorized by Merchandise to do so (II, 483-487) and that LeRoy then told Johnson that one of Merchandise's clerks had mailed the advice of credit by mistake (II, 484-485; 487-488).

Then LeRoy testified:

"Q. Mr. LeRoy, did you tell Johnson at that time that the Merchandise Bank wanted to revoke that advice of credit?
A. I said we had revoked it.
Q. You said you had already revoked it, is that right?
A. Yes, sir" (II, 487-488).

"Q. When you asked Duncan and Johnson, and when you discussed with them the revocation of the credit, you were asking them also for the help of the Bank of America?

A. In the return of the advice of credit but not in the revocation of it. That had already been done.

Q. When?

A. On the afternoon that Mr. Messenger telephoned to Mr. Estribou" (II, 492-493).

LeRoy then went on to testify that after some discussion Johnson said that Merchandise was "entirely within its rights in revoking this credit" and that he (Johnson) wanted to telephone to Estribou because Bank of America would pay "against that credit at their peril" (II, 459).

After these conversations LeRoy signed and delivered to Duncan a letter to Bank of America, dated November 18th, which had been prepared in Bank of America's office (II, 496-497). This letter (pltf's. ex. 10; IV, 1171-1173) states that Merchandise authorizes Bank of America to return without protest the Lofendo checks, the fate of which LeRoy wanted to determine; and then it goes on to say that on November 15th Merchandise received a collection letter from Bank of America accompanying the six checks; that the six checks "are not being accepted by us and will be returned to" the Branch; and "this letter will serve as your authority to return our credit advice which was sent to you in error * * *" (IV, 1171-1172).

In his conversations with Duncan and Johnson, LeRoy took the position that one of Merchandise's clerks had mailed the advice of credit by mistake;

that for that reason Merchandise had revoked the advice of credit; and that he in his conversations with Duncan and Johnson was not requesting that Bank of America consent to the revocation of the credit, but was only confirming the fact that it had been revoked.

As in the case of the conversations between Messenger and Estribou, the conversations between LeRoy and Duncan and Johnson had none of the characteristics of a binding bargain. There was no intention to create a contract and none was created.

It follows that the findings of the trial court, that on November 17th and again on November 18th Bank of America agreed with Merchandise not to act upon the advice of credit, are not supported by the evidence and are erroneous.

2. Assuming a contract, it was invalid because not supported by a consideration.

If Messenger's conversation with Estribou or LeRoy's with Duncan and Johnson did create a contract, what was it?

According to Merchandise, it was a contract which would bring about what it desired, that is, a contract under which it was agreed that Merchandise's payment of the six checks should be rescinded and that Bank of America should not credit the amount of this payment to the account but should give up whatever rights it might have therein and repay it to Merchandise.

Merchandise had the burden of establishing the consideration for the alleged contract. 17 C.J.S. 1220-1222. But Duncan testified that Bank of America received nothing in the transaction (II, 553). LeRoy testified that he did not offer or promise anything to Bank of America for its alleged contract (II, 494-496). And the evidence shows that Bank of America (the promisor) received no benefit, and Merchandise (the promisee) suffered no prejudice, as an inducement for Bank of America's alleged promise. Therefore it was not supported by a consideration and is invalid. Secs. 1605 and 1550 of the California Civil Code and 6 Cal. Jur. 164-167, secs. 114 and 115.

3. Assuming a contract, it was invalid because based on mistake.

Messenger testified that in his telephone conversation with Estribou, the latter said that the Branch had not been paying against uncollected funds and that it was in the clear, that it had a balance of $699.02 (I, 225).

LeRoy testified that Duncan after talking with Estribou on the telephone told him that Estribou had reported that there was a credit balance of about $690 in the Lofendo account (II, 455). Duncan testified that he had a telephone conversation with both Estribou and Tarr, but that he talked principally with Tarr; and that he told LeRoy that Tarr had informed him that the Lofendo account was "in the black" and that the Branch would not take any loss on the account (II, 541-555).

LeRoy testified that when he was talking with Duncan and Johnson, Johnson telephoned Estribou (II, 491); and that he could not recall distinctly whether Johnson asked Estribou the status of the Lofendo account, but that his best recollection was that Johnson probably did (II, 492). Johnson testified that in this telephone conversation, Estribou told him that there was a credit balance in the account (II, 696).

And so the evidence is uncontradicted that Estribou talked to Messenger and Duncan and Johnson talked to LeRoy on the basis that there was a good credit balance to Lofendo's account.

But as already stated, on November 15th the Branch by mistake gave Lofendo credit for the checks for $97,207.00 upon the deposit of these checks in the Branch and before their collection and it did not discover this mistake until it received the wire from the Continental Illinois late in the afternoon of November 18th that the checks had been rejected (IV, 1177-1179; I, 374-375). And as already stated, at the close of business on November 17th, Lofendo had drawn against these uncollected funds in the sum of $82,281.74 and so was indebted to the Branch in that amount. The advice of credit for the six checks arrived at the Branch on November 19th (IV, 1177); and on that day the Branch credited the amount of the checks to the Lofendo account and debited the checks for $97,207.00 against it (IV, 1179). And

on November 20th the Branch refused to deliver the advice of credit to LeRoy and charged the six checks against Merchandise's account (II, 461-466; I, 175-180).

In short, the evidence shows without conflict that if the alleged contract was made, (a) it was made in the mistaken belief of both Merchandise and Bank of America that there was a good balance to the credit of Lofendo when in fact Lofendo was overdrawn in the sum of $82,281.74; and (b) when Bank of America discovered its mistake, it rescinded the contract.

It is perfectly obvious that if Bank of America had not believed that there was a good balance to Lofendo's credit and had known that he was overdrawn in the sum of $82,281.74, it would never have entered into the alleged contract providing that Merchandise could rescind the payment of the six checks and recover it back. Men just don't behave that way.

Bank of America had the right to rescind the alleged contract on the ground of mistake. California Civil Code, secs. 1567, 1568, 1577 and 1689. Sec. 1567 provides that "consent is deemed to have been obtained by" mistake "only when it would not have been given had such cause not existed". It cannot be doubted that Bank of America would not have consented to the alleged contract but for its mistake.

The subject matter of the alleged contract was the Lofendo account. The question was whether Bank

of America should credit the amount of the six checks to that account or agree not to do so. Therefore Bank of America's mistake respecting the status of that account "affected the substance of the whole transaction". The mistake therefore was of the sort which justified a rescission. *Hannah v. Steinman,* 159 Cal. 142, 146-149, 112 P. 1094, 1096-1097.

4. Assuming a contract, it was invalid because induced by Merchandise's fraud.

In their telephone conversation, Messenger told Estribou that the advice of credit had been sent out in error (I, 223); and in their conferences, LeRoy told Duncan and Johnson that one of Merchandise's clerks had mailed the advice of credit by mistake when it should not have been mailed (II, 484-485); that it had been sent out in error because the six checks had been charged against fictitious credits (II, 487).

Neither Messenger's statement nor LeRoy's was true. As we have seen, when Merchandise in paying the six checks charged them against United's account, there was a good credit balance in the account consisting mainly of the proceeds of loans made by Merchandise to United and evidenced by United's notes. Merchandise's error did not consist in sending out the advice in error, or in charging the checks against fictitious credits, but in making United the loans which were then credited to its account.

Messenger and LeRoy not only made these untrue statements to Bank of America to induce it to enter

into the alleged contract, but they also failed to disclose to Bank of America facts which they were under a duty to disclose.

Section 1710 of the California Civil Code provides that deceit is "the suppression of a fact by one * * * who gives information of other facts which are likely to mislead for want of communication of that fact". And in *American Trust Co. v. California Western States Life Insurance Company,* 15 Cal. (2d) 42, 98 P. (2d) 497, the court said at page 65:

> "Regardless of whether one is under a duty to speak or disclose facts, one who does speak must speak the whole truth, and not by partial suppression or concealment make the utterance untruthful and misleading. This doctrine is declared by our Civil Code (sec. 1710, subd. 3), and is everywhere recognized as a sound rule of law."

See also, 37 C.J.S. 245-246.

When Messenger and LeRoy spoke, they were at the least under a duty to advise Bank of America that Merchandise by its negligence had permitted United to continue the kite and that it was asking Bank of America to agree to a rescission of the payment of the six checks in order to reduce the losses which Merchandise was to take by reason of the kite. If they had said this and if at the same time they had said what they testified they said (that is, that Merchandise was rescinding the advice), there is every reason to believe that the others would not have responded as Messenger and LeRoy say they responded (that is, by stating in effect that they

would accept the direction that the advice had been rescinded); but that they would have taken the position that under such circumstances they would not accept such direction, but would await developments.

5. Conclusion with respect to this point.

The evidence shows without conflict that there was no intent on the part of anyone to enter into a contract providing that Merchandise's payment of the six checks should be rescinded and that Bank of America should surrender whatever rights it might have in the payment and restore it to Merchandise. And no such contract was made.

But assuming that such a contract was made, it was invalid because not supported by a consideration and because induced by mistake and fraud.

J. RECAPITULATION.

Merchandise paid the checks; and when it paid them and pursuant to the collection letters credited Bank of America, Bank of America ceased to be the agent and Merchandise the sub-agent for their collection; and thereupon Merchandise became indebted to Bank of America and Bank of America to Lofendo in the amounts of the payments.

Merchandise cannot recover from Bank of America the former's payments of the four and six checks upon the ground of mistake, because Bank of America had a lien on the proceeds of the checks and is

therefore in the position of a bona fide purchaser; and because Merchandise received a substantial benefit from the payments of the checks and, therefore, in equity and good conscience is precluded from recovering them.

In addition Bank of America became a bona fide purchaser of the payment of the four checks and entitled to return such payment for the reasons summarized on pages 68 to 69 of this brief; and it acquired the same position with respect to the payment of the six checks for the reasons stated on pages 69 to 72 of this brief.

The issue raised by Bank of America's answer, that Merchandise knew or should have known of the kite, was a defense to the action and therefore the trial court's failure to find with respect to this issue is reversible error. It constituted a defense for the reasons summarized on pages 106 to 107 of this brief. And the court should have found respecting it because it was an essential element of Bank of America's entirely proper counter-claim.

No contract for the rescission of the payment of the six checks was intended or made; but if such a contract was made, it was invalid.

The fundamental fact underlying all of the technical points involved in this case is that Merchandise's loss was due to the kite and that it by following a most extraordinary and, to say the least, flagrantly negligent course of behavior allowed the kite to continue. It is, therefore, just and equitable that

it should bear the loss which it brought upon itself and that it should not recover any part of this loss from Bank of America.

Dated, San Francisco, California,
December 10, 1951.

Respectfully submitted,
S. B. Stewart, Jr.,
G. D. Schilling,
Morse Erskine,
Erskine, Erskine & Tulley,
Attorneys for Appellants.

(Appendix Follows.)

Appendix.

Appendix

THE TRIAL COURT'S FINDING THAT PLAINTIFF RECEIVED THE LOFENDO REMITTANCE CHECKS FOR COLLECTION AND THAT IT GAVE UNITED CONDITIONAL CREDITS FOR THESE CHECKS (I, 99), IS NOT SUPPORTED BY THE EVIDENCE.

This finding is based upon the form of assignment of accounts receivable (pltf's. ex. 6) executed by United to Merchandise each month which read in part as follows:

> "The undersigned United Produce Company agrees whenever it receives checks from its customers to endorse them over to the Bank for collection and the Bank will take and handle them for collection."

It is also based upon a provision printed on the back of the deposit slip used by Merchandise (pltf's. ex. 7) reading as follows:

> "In receiving and handling items for deposit or collection * * * all items are credited or cashed subject to final payment in cash or solvent credits. * * *
>
> The bank may charge back any item at any time before final payment, whether returned or not. * * *"

The deposit tags did not accompany the Lofendo checks received as remittances (I, 236).

A deposit slip, of course, is used by a bank to accompany deposits made to the credit of a customer; that is why it is called a deposit slip. And the con-

tract stated on the back of Merchandise's deposit slip states Merchandise's right to charge back when items are deposited with it either for immediate credit or for collection.

But the Lofendo checks were not deposited by United in its commercial account and were not accepted by Merchandise in the commercial account of United either for collection or credit. On the contrary, these checks were delivered to Merchandise as remittances on account of accounts receivable; and when received they were in effect applied on account of United's indebtedness to Merchandise. The checks, therefore, did not create credits at all, but were in effect payments. When the checks were dishonored, the result was to restore the indebtedness on account of which the checks had been applied; but the checks were not dishonored until after November 15th, and so Merchandise's right to charge such indebtedness against United's commercial account did not arise until after that date and was not in fact exercised until after that date, and so the balance to United's credit on November 15th against which the six checks were charged was a good balance not diminished by any such offset.

LeRoy's testimony with respect to these transactions was a correct description of them. He testified that checks received as remittances would be applied on account of the indebtedness of United to Merchandise (II, 504); and that when any such check was rejected by the bank on which it was drawn the situation was

the same as though no payment in the amount of such check had been made on account of United's indebtedness (II, 506-507); and that the effect of such rejection was to leave unpaid that part of United's indebtedness to Merchandise on account of which the check had been applied unless there were funds in the commercial account against which it could be charged (II, 507-508).